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Department
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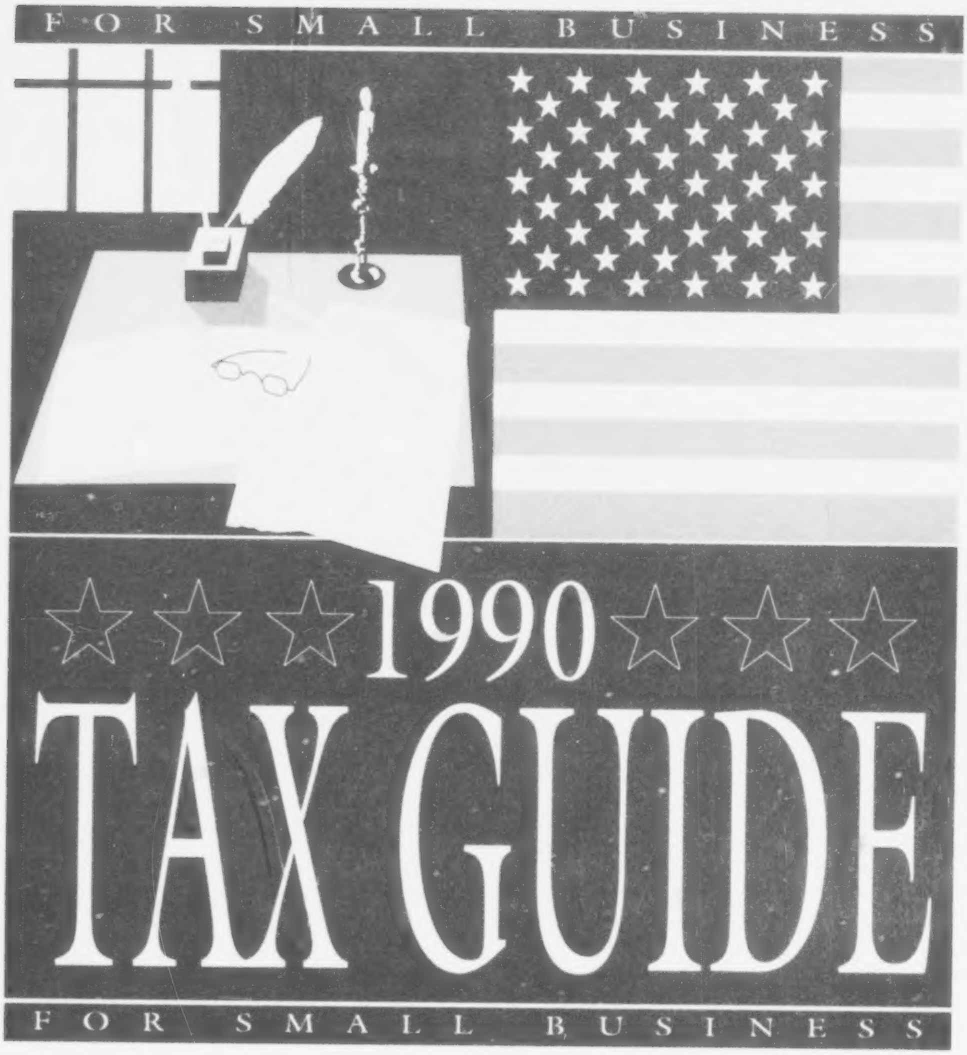
Treasury
Internal
Revenue
Service

Tax Guide for Small Business

Income, Excise, and Employment Taxes for
Individuals, Partnerships, and Corporations

Publication 334
For use in preparing
1990 Returns


FOR SMALL BUSINESS
1990
TAX GUIDE
FOR SMALL BUSINESS

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The explanations and examples in this publication reflect the interpretation by the Internal Revenue Service (IRS) of:

- Tax laws enacted by Congress,
- Treasury regulations, and
- Court decisions.

However, the information given does not cover every situation and is not intended to replace the law or change its meaning.

The publication covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing interpretations are resolved by higher court decisions or in some other way, this publication will continue to present the interpretation of the Service.

All taxpayers have appeal rights within the Service and may appeal to the courts when they do not agree with the interpretations taken by the Service. For a discussion on appeal procedures, see *The Examination and Appeals Process* in this publication.

All material in this publication may be reprinted freely. A citation to *Tax Guide for Small Business (Rev. Nov. 90)* would be appropriate.

Introduction

This publication contains information about the federal tax laws that apply to businesses. It describes the four major forms of business organization—sole proprietorship, partnership, corporation, and S corporation—and explains the tax responsibilities of each.

This edition of *Tax Guide for Small Business* is divided into eight parts. The first part contains general information on business organization and accounting practices. Part II discusses the tax aspects of accounting for the assets used in a business.

Parts III and IV explain how to figure your business income for tax purposes. They describe the kinds of income you must report and the different types of business deductions you can take.

Part V discusses the rules that apply when you sell or exchange business assets or investment property. It includes chapters on the treatment of capital gains and losses, and on involuntary conversions, such as theft and casualty losses. The chapters in Part VI bring together some specific tax considerations for each of the four major forms of business organization.

Part VII looks at some of the credits that can reduce your income tax, and some of the other taxes you may have to pay in addition to income tax. It also discusses the information returns that may have to be filed. The last part shows how to fill out the main income tax forms businesses use.

The information in this publication applies to many different kinds of businesses. However, the publication does not discuss foreign corporations, insurance companies, collapsible corporations, personal holding companies, banks, regulated investment companies, small business investment companies, real estate investment trusts, foreign sales corporations (FSCs), and integrated oil companies. It also does not discuss bankruptcy or corporate reorganizations and acquisitions.

The problems related to farming and commercial fishing are covered in two other tax information publications. If you run a farm or are in the fishing business, you should obtain a copy of *Farmer's Tax Guide* (Publication 225) or *Tax Guide for Commercial Fishermen* (Publication 595).

For information on the individual income tax, you may want to see the companion volume to this publication, *Your Federal Income Tax* (Publication 17).

In addition to these publications, the Internal Revenue Service has many other tax publications that may be of interest to you. Most of them are concerned with particular areas of tax law, such as depreciation, selling a home, rental property, retirement income, or installment sales. You will find references to many of these publications throughout the publication. They are all available free from the Forms Distribution Center for your area. Use the order blank at the end of this publication.

Other federal agencies also publish publications and pamphlets designed to assist small businesses. The Small Business Administration has a number of helpful publications. For a list of these publications, ask for Publication SBA 115A—M at the Small Business Administration local office listed in your area telephone directory or write to:

Small Business Administration
Office of Business Development
1441 L Street N.W.
Washington, DC 20416

For a list of federal publications that are for sale, including many from the Small Business Administration, write to:

Superintendent of Documents
Washington, DC 20402

Ask for MP12, *Going Into Business,* and FM10, *Recordkeeping In A Small Business.* Both are available at a small fee.

We welcome your suggestions for future editions of this publication. Please send your ideas to:

Internal Revenue Service
Technical Publications Branch (T:FP:P)
1111 Constitution Avenue N.W.
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you include your area code and daytime phone number along with your return address.

Important Changes for 1990

The following list highlights a number of changes in the tax law and administrative changes for 1990. A second list of items under *Important Reminders* contains information that may be helpful to know in preparing your tax return for 1990.

New legislation. This publication has been revised to include tax law changes from the Revenue Reconciliation Act of 1990. Specifically, we have made changes to: employment taxes, self-employment taxes, tax credits, employer-provided educational assistance payments and legal services plans.

For more information on these and other changes, see Publication 553, *Highlights of 1990 Tax Changes.*

Change of address. If you change your mailing address, you should use Form 8822, *Change of Address,* to notify IRS of your new address. Be sure to include your suite, room, or other unit number. If you are changing both your home and business addresses, please complete two separate forms. However, individuals who are also household employers and file Form 942 can use one form. Send the form to the Internal Revenue Service Center for your old address.

Standard mileage rate for business use of a vehicle. The standard mileage rate for 1990 is 26 cents a mile for all business miles. Beginning in 1990, you are not subject to the 15,000 mile annual limit, which applied in prior years. See Chapter 15.

New wage maximums and tax rates for self-employment taxes. In 1990, the tax rate for self-employment taxes is 15.3% on net earnings up to a maximum of $51,300. The 15.3% tax rate is a total of 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). In 1991, the tax rate will remain at 15.3% but the maximum net earnings subject to the social security portion (12.4%) increase to $53,400, while the maximum net earnings subject to the Medicare portion (2.9%) increase to $125,000. See Chapter 32.

New wage maximums and tax rates for social security taxes. In 1990, the tax rate for social security taxes is 7.65% for both the employee and the employer (a total of 15.3%) on wages up to $51,300. The 7.65% tax is a total of 6.2% for social security (old-age, survivors, and disability insurance) and 1.45% for Medicare (hospital insurance). In 1991, the tax will remain at 7.65% but the maximum wages subject to the social security portion (6.2%) increase to $53,400, while the maximum wages subject to the Medicare portion (1.45%) increase to $125,000. See Chapter 33.

New $100,000 deposit rule. After 1990, undeposited social security and withheld income taxes that reach $100,000 or more in any eighth-monthly deposit period must be deposited on the next banking day. However, you are still required to make deposits within 3 banking days when undeposited taxes reach at least $3,000 at the end of an eighth-monthly deposit period. See Chapter 33.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% through 1991. See Chapter 33.

General business credit. The following credits, which are part of the general business credit, are extended through December 31, 1991: jobs credit, research credit, energy investment credit, and low-income housing credit. See Chapter 31.

Disabled access credit. An eligible small business is allowed a nonrefundable tax credit for expenses paid or incurred after November 5, 1990. This credit is equal to 50% of the amount of eligible access expenses for the tax year that are more than $250 but not more than $10,250. Generally, an eligible small business is one which in the preceding tax year had either gross receipts of not more than $1,000,000 or no more than 30 full-time employees. See Publication 553, *Highlights of 1990 Tax Changes,* for more information.

Cellular telephones. Any cellular telephone or similar telecommunications equipment placed in service in tax years beginning after December 31, 1989, is listed property. If listed property is not used more than 50% for qualified business use during any tax year, the section 179 deduction is not allowable and the property must be depreciated using the alternate MACRS method over the class life of the property. All the rules for listed property apply to cellular telephones or similar telecommunications equipment. See Publication 534, *Depreciation,* for a discussion of listed property.

Educational assistance. The income exclusion for employer-provided educational assistance payments is extended through tax years beginning before January 1, 1992. See Chapter 10.

Group legal services plan. The exclusion for employer-provided group legal services plans is extended through tax years beginning before January 1, 1992. See Chapter 10.

Medical insurance for self-employed persons. If you are self-employed or if you own more than 2% of the outstanding stock of an S corporation, you can deduct up to 25% of the cost paid on your behalf for providing medical insurance for yourself and your family, if you meet certain requirements.

The expiration date for this deduction has been extended to tax years beginning before January 1, 1992. See Chapters 17 and 30.

Nonaccountable plans. For employment tax purposes, you must treat as wages any amounts you pay your employees as reimbursement of their employee business expenses if these amounts are paid or are treated as paid under a nonaccountable plan. This means that you must report the amounts as wages on your employees' Forms W–2. You must withhold and pay employment taxes on these amounts. See Chapter 15.

Franchises, trademarks, and trade names. The deductibility for the amounts you pay or incur to buy a franchise, trademark, or trade name that are contingent on the productivity, use, or disposition of the items bought, depends on whether certain rules are met. See Chapter 19.

New Form 8824. Beginning in 1990, if you have a like-kind exchange, you must file Form 8824, *Like-Kind Exchanges*, in addition to Schedule D (Form 1040) or Form 4797. See Chapters 21 and 26.

Like-kind exchanges. Restrictions have been added to the rules allowing a tax-free exchange of like-kind property. If related parties exchange like-kind property, they must wait 2 years before either can sell or dispose of the property exchanged. See Chapter 21.

Installment sales. If you use an installment obligation to secure any debt, the net proceeds from that debt may be treated as a payment on the installment obligation. This rule applies if the sales price of the property was more than $150,000. It does not apply to an obligation from the sale of any property used by the taxpayer in the trade or business of farming or produced by the taxpayer in the trade or business of farming or from the sale of personal use property by an individual. See Chapter 24.

Alternative minimum tax. For tax years beginning after 1989, the following changes have been made to the corporate minimum tax rules.

The ***alternative depreciation system*** is used for property placed in service after 1989. This requires use of the straight-line method over a recovery period.

Intangible drilling costs are capitalized and amortized over a 60–month period beginning with the month the costs were paid or incurred.

Depletion is computed using the cost depletion method for property placed in service after 1989.

The ***credit*** allowed against regular tax for alternative minimum tax on deferral and exclusion items paid in previous years is increased by any credit not allowed by the limit for orphan drugs or nonconventional fuels.

The ***limit on foreign tax credit*** does not apply to certain corporations.

For ***home construction contracts*** entered into in tax years beginning after September 30, 1990, do not use the percentage of completion method to figure alternative minimum taxable income relating to those contracts.

See Chapter 34.

Estimated tax payments for S corporations. For tax years beginning in 1990, an S corporation must make quarterly estimated tax payments if its expected liability is $500 or more for the tax on net recognized built-in gain, on excess net passive income, and on any increase in tax for which the S corporation is liable because of the recapture of investment credits. See Chapter 30.

Penalties. Beginning in 1990, the following penalties for late tax deposits and late information returns are based on the length of time a deposit or information return is late. The penalty for furnishing statements to payees, however, is not time-related.

- ***Late tax deposits.*** After 1989, the penalty for a late tax deposit is:
  - a) 2% for the first 5 days late,
  - b) 5% for the 6th through the 15th day late,
  - c) 10% for more than 15 days late, and
  - d) 15% if the deposit is not made within 10 days after the IRS issues the first notice demanding payment.
- ***Late information returns.*** After 1989, the penalty for filing a late information return applies if you do not file by the due date, if you do not include all required information, or if you report incorrect information. The penalty is:
  - a) $15 for each return filed within 30 days after the due date, up to a maximum of $75,000,
  - b) $30 for each return filed after the 30–day period but by August 1, up to a maximum of $150,000, and
  - c) $50 for each return filed after August 1, or never filed, up to a maximum of $250,000.

  Small businesses pay the same penalty for a return, but the maximums are lowered to $25,000, $50,000, and $100,000. A small business is one with average annual gross receipts of $5 million or less for the last 3 years ending before the calendar year the return is due, or since the business began if shorter.
- ***Late payee statements.*** After 1989, a $50 penalty applies for each statement you do not furnish a payee by the required date up to a maximum of $100,000. The penalty also applies if you do not include all required information, or if you report incorrect information.

Important Reminders

Earned income credit. You, as an employer, must notify employees who worked for you and from whom you did not withhold income tax about the earned income credit. See Chapter 33.

Form W–4 for 1991. You should make new Forms W–4 available to your employees and encourage them to check their income tax withholding for 1991. Those employees who owed a large amount of tax or received a large refund for 1990 may need to file a new Form W–4. See Chapter 33.

Children employed by parents. Wages you pay to your children age 18 and older for services in your trade or business are subject to social security taxes. See Chapter 33.

Employees' tips. All tips reported by an employee are subject to the employer portion of the social security tax. Thus, you must pay the employer social security tax on the total amount of tips and wages up to the social security maximum. See Chapter 33.

Information returns (Form 1099 series). If you make total payments of $600 or more during the year to another person, other than an employee or a corporation, in the course of your business, you must file information returns to report these payments for the year. See Chapter 36.

Penalties. Besides the following penalties that apply to 1990 returns, ***criminal penalties*** may be imposed for willful failure to file, collect, or pay, for tax evasion, and for making a false statement.

- The fraud penalty for underpayment of income, gift, or windfall profit taxes, is 75% of the part of the underpayment due to fraud.
- A 20% penalty applies to the underpayment of income tax due to negligence or disregard of IRS rules and regulations. This penalty also applies to any substantial understatement of income tax, valuation overstatement, pension liabilities overstatement, and estate or gift tax valuation understatement.
- The penalty for not registering tax shelters with the IRS is the greater of 1% of the amount invested in the tax shelter, or $500.
- The penalty for not including tax shelter identification numbers on returns is $250 for each number omitted.
- The penalty on tax shelters for not keeping lists of investors in potentially abusive tax shelters is $50 for each person required to be on the list. The maximum penalty is $100,000 for each tax shelter in each tax year.
- The penalty for failure to pay tax is ½ of 1% of the unpaid tax for each month, or part of a month, the tax is unpaid. However, the penalty increases to 1% for each month beginning after the day levy is made.

Taxpayer assistance. Publication 910, *Guide to Free Tax Services*, provides information on where to get help in preparing tax returns. It describes the kind of year-round services available in resolving questions on bills, letters, and notices received from Service

Centers, as well as questions on the status of tax refunds. This publication lists free taxpayer information publications, with brief descriptions of their content, along with a list of related tax forms and schedules you may need to complete your returns.

For information on how to get Publication 910, see *How to Get IRS Forms and Publications,* at the end of this publication.

Tele-Tax. The IRS has a telephone service called Tele-Tax. This service provides recorded tax information tapes on about 140 topics covering such areas as filing requirements, employment taxes, taxpayer identification numbers, and tax credits. Recorded tax information is available 24 hours a day, 7 days a week, to taxpayers using push-button telephones, and during regular working hours to those using dial telephones. The topics covered and telephone numbers for your area are listed in the Form 1040 instructions.

Unresolved tax problems. IRS has a Problem Resolution Program for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you have been unable to resolve through normal channels, write to your local IRS District Director or call your local IRS office and ask for Problem Resolution assistance.

The Problem Resolution Office will take responsibility for your problem and ensure that it receives proper attention. Although this office cannot change the tax law or technical decisions, it can frequently clear up misunderstandings that resulted from previous contacts.

Hearing-impaired taxpayers who have access to TDD equipment may call 1–800–829–4059 to ask for help from Problem Resolution.

Small business workshops. Workshops are offered for self-employed or small business owners who want to learn about the tax aspects of running their businesses. For details, call IRS at the number listed in your telephone directory under U.S. Government and ask for the Taxpayer Education Coordinator.

Reminders—Before you file your tax return, be sure to: Attach all forms and schedules in sequence number order. The sequence number is just below the year in the upper right corner of the schedule or form. Attach all other statements or attachments last, but in the same order as the forms or schedules they relate to. Do not attach these other statements to the related form or schedule.

Fill out Schedule SE (Form 1040) if you had self-employment income of $400 or more.

List income, deductions, credits, and tax items on the correct lines.

Make sure the tax return is signed and dated.

Use address label. Transfer the address label from the tax return package you received in the mail to your tax return, and make any necessary corrections.

Pay by check. Attach a check for any tax you owe. If the check accompanies your Form 1040, write your social security number on the check. If the check accompanies Form 1120, Form 1120–A, or Form 1120S, write your employer identification number, the tax period, and the tax form number on the check. Also include the telephone number and area code where you can be reached during the day.

Rounding off dollars. You may round off cents to the nearest whole dollar on your return and schedules. To do so, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, $1.39 becomes $1 and $2.50 becomes $3.

If you do round off, do so for all amounts. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and only round off the total.

Business codes. You must enter on the appropriate line of your return a code that identifies your principal business or professional activity. See the sample returns in Part VIII.

Part I
The Business Organization

This Part looks at some of the things you must consider when setting up a business. The first chapter briefly describes the major forms of business organization and discusses how each is taxed. The other chapters discuss recordkeeping, accounting periods, and accounting methods.

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1. Initial Considerations

Once you have decided to start a business, you must decide what type of business entity to use. There are legal and tax considerations that will enter into this decision. The legal considerations are beyond the scope of this publication. However, an important element in your decision will be the tax consequences of each type of entity. Normally, a business is conducted in the form of a sole proprietorship, a partnership, or a corporation.

For a sole proprietorship or a partnership, the business itself does not pay any income taxes. The sole proprietor or the partners include the profits or losses on their income tax returns. Except for an S corporation (discussed in Chapter 30), profits of a corporation are taxed both to the corporation and to the shareholders when the profits are distributed as dividends. Also, except for an S corporation, losses sustained by the corporation usually are not available to its stockholders.

The tax considerations related to the costs of getting started in a business are discussed under *Going Into Business* in Chapter 5.

Sole proprietorships. A sole proprietorship is the simplest form of business organization. The business has no existence apart from you, the owner. Its liabilities are your personal liabilities, and your proprietary interest ends when you die. You undertake the risks of business to the extent of all assets, whether used in the business or personally owned.

Profit or loss. When you figure your taxable income for the year, you must add in any profit, or subtract out any loss, you have from your sole proprietorship. You must report the profit or loss from each of your businesses operated as a sole proprietorship on a separate Schedule C (Form 1040), *Profit or Loss From Business.* The amount of this business profit or loss is entered as an item of profit or loss on your individual income tax return Form 1040.

If you are a sole proprietor, you are probably liable for ***self-employment tax*** (see Chapter 32). You ordinarily will have to make estimated tax payments (see Chapter 27).

Assets. Each asset in your sole proprietorship is treated separately for tax purposes, rather than as part of one overall ownership interest. For example, a sole proprietor selling an entire business as a going concern figures gain or loss separately on each asset. See Chapter 27 for information on the sale of your sole proprietorship.

Rules. Other rules explained in this publication apply to sole proprietorships unless stated otherwise.

Partnerships. A partnership is not a taxable entity. However, it must figure its profit or loss and file a return. A partnership files its return on Form 1065, *U.S. Partnership Return of Income.*

A partnership is the relationship existing between two or more persons who join together to carry on a trade or business. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business.

For income tax purposes, the term partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization that is carrying on a business and that is not classified as a trust, estate, or corporation.

A joint undertaking to share expenses is ***not*** a partnership. Mere co-ownership of property that is maintained and leased or rented is ***not*** a partnership. However, if the co-owners provide services to the tenants, a partnership exists.

Partnership agreement. The partnership agreement includes the original agreement and any modifications of it agreed to by all the partners or adopted in any other manner provided by the partnership agreement. The agreement or modifications may be oral or written.

Generally, a partner's share of income, gain, loss, deductions, or credits is determined by the partnership agreement.

The partnership agreement may be modified for a particular tax year after the close of that tax year, but not later than the date, not including any extension of time, for filing the partnership return.

However, the partnership agreement or any modification of it will be disregarded if the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or of any item in these categories) does not have substantial economic effect.

In any matter on which the partnership agreement, or any modification of it, is silent, the provisions of local law are considered to be a part of the agreement.

Partnerships excluded. Some partnerships may choose to be excluded, completely or partially, from being treated as partnerships, for federal income tax purposes, if all the members agree. The exclusion applies only to certain investing partnerships and operating agreements where there is no active conduct of a business. It applies to the joint production, extraction, or use of property, but not for selling services or property produced or extracted. The members of such an organization must be able to figure their income without having to figure partnership taxable income.

For more information on partnerships, see Chapter 28.

Corporations. Corporate profits normally are taxed to the corporation. When the profits are distributed as dividends, the dividends are taxed to the shareholders.

In figuring its taxable income, a corporation generally takes the same deductions as a sole proprietorship. Corporations also are entitled to special deductions that are discussed in Chapter 29.

A corporation, for federal income tax purposes, includes associations, joint stock companies, insurance companies, and trusts and partnerships that actually operate as associations or corporations.

Organizations of professional people. Organizations of doctors, lawyers, and other professional people organized under state professional association acts are generally recognized as corporations for federal income tax purposes. A professional service organization must be both ***organized*** and ***operated*** as a corporation to be classified as one. All of the states and the District of Columbia have professional association acts.

Unincorporated organizations. Organizations that are unincorporated and have certain corporate characteristics are classified as associations and are taxed as corporations. These organizations must have associates and must be organized to carry on business and divide any gains. In addition, they must have a ***majority*** of the following characteristics:

1) Continuity of life,
2) Centralization of management,
3) Limited liability, and
4) Free transferability of interests.

Other factors may also be significant in classifying an organization as an association. An organization will be treated as an association if its characteristics are such that it more nearly resembles a corporation than a partnership or trust. The facts in each case determine whether or not the characteristics are present.

Income tax return. A corporation must file an income tax return unless it has dissolved. This applies even if it has ceased doing business and has disposed of all of its assets except for a small sum of cash retained to pay state taxes to keep its corporate charter. It may be required to file a return for any year following the year in which it has been dissolved, if it carries on substantial activities such as the collection of assets or the payment of obligations in connection with the termination of its business affairs.

A corporation with no assets is not required to file an income tax return after it stops doing business and dissolves. This is so even if it is treated as a corporation under state law for limited purposes connected with winding up its affairs, such as suing or being sued. Most corporations file Form 1120, *U.S. Corporation Income Tax Return,* or Form 1120-A, *U.S. Corporation Short-Form Income Tax Return.*

Formation. Forming a corporation involves a transfer of either money, property, or both, by the prospective shareholders in exchange for capital stock in the corporation.

If money is exchanged for stock, no gain or loss is realized by the shareholder or the corporation. The stock received by the shareholder has a basis equal to the amount of money transferred to the corporation by the shareholder.

If property is exchanged for stock, it may be a nontaxable exchange of property for stock, as discussed in Chapter 21. In other cases, the shareholder who transfers the property to the corporation will realize a taxable gain or loss. Under certain circumstances, as explained under *Sales and exchanges between related parties* in Chapter 22, any gain recognized which ordinarily would be a capital gain may have to be treated as an ordinary gain, and any loss may be nondeductible.

The gain or loss on a ***taxable exchange*** is figured by comparing the adjusted basis of the property transferred with its fair market value at the time of the transfer to the corporation. This may be a capital gain or loss. See Chapter 22.

For more information on corporations, see Chapter 29.

S corporations. A qualifying corporation may choose to be generally exempt from federal income tax. Its shareholders will then include in their income their share of the corporation's separately stated items of income, deduction, loss, and credit and their share of nonseparately stated income or loss. A corporation that makes this choice is known as an S corporation.

Although it generally will not be liable for federal income tax, an S corporation may have to pay a tax on excess net passive investment income, a tax on capital gains, a tax on built-in gains, or the tax from recomputing a prior-year's investment credit. An S corporation files its return on Form 1120S, *U.S. Income Tax Return for an S Corporation.*

To make this election, a corporation, in addition to other requirements, must not have more than 35 shareholders. Also, each of its shareholders must consent to the election.

For more information on S corporations, see Chapter 30.

Taxpayer Identification Number

You generally use your ***social security number*** as your taxpayer identification number. You must put this number on each of your individual income tax forms, such as Form 1040 and its schedules.

However, every partnership, and corporation (including S corporations) must have an ***employer identification number*** (EIN) to use as its taxpayer identification number. Sole proprietors must also have EINs, if they:

1) Pay wages to one or more employees, or
2) Must file any pension or excise tax returns, including those for alcohol, tobacco, or firearms.

If you are required to have an EIN, include it along with your social security number on your Schedule C (Form 1040). Otherwise, sole proprietors can use their social security numbers as their business taxpayer identification numbers.

Application for identification number. To apply for a social security number, you should use ***Form SS-5,*** *Application for a Social Security Number Card.* If you are under 18 years of age, you must furnish evidence, along with this form, of age, identity, and U.S. citizenship. If you are 18 or older, you must appear in person with this evidence at a Social Security office. If you are an alien, you must appear in person and bring your birth certificate and either your alien registration card or your U.S. immigration form. This form is available from Social Security Administration offices and by calling 1-800-829-3676.

To apply for an EIN, use Form SS-4, *Application for Employer Identification Number.* This form is available from IRS and Social Security Administration offices.

Payments to others. If you make payments that require an information return, you must include the payee's taxpayer identification number on the information return. See Chapter 36.

To get the payee's number, use ***Form W-9,*** *Request for Taxpayer Identification Number and Certification.* This form is available from the IRS. A payee who does not provide you with an identification number may be subject to backup withholding of 20% on the payments you make.

Penalties. After 1989, a $50 penalty applies for each failure to comply by the required due date with certain specified information reporting requirements, up to a maximum of $100,000 for all such failures. Most of these requirements concern furnishing and including taxpayer identification numbers on returns, statements, and other documents. See Chapter 36 for more information on penalties.

New EIN. You may need to get a new EIN if either the form or the ownership of your business changes.

Change in organization. A new EIN is required for the following changes:

1) A sole proprietorship incorporates;
2) A sole proprietorship takes in partners and operates as a partnership;
3) A partnership incorporates;
4) A partnership is taken over by one of the partners and is operated as a sole proprietorship; or
5) A corporation changes to a partnership or to a sole proprietorship.

If a corporation chooses to be taxed as an S corporation, it does not need a new EIN.

Change in ownership. A new EIN is required for the following changes:

1) You purchase or inherit an existing business that you will operate as a sole proprietorship (you cannot use the EIN of the former owner, even if he or she is your spouse);
2) You represent an estate that operates a business after the owner's death; or
3) You terminate an old partnership and begin a new one.

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2. Books and Records

You must keep records to correctly figure your taxes. The *Checklist* on the back cover lists the due dates of various taxes that might apply to your business. Your records must be permanent, accurate, complete, and must clearly establish your income, deductions, credits, and employee information. The law does not require you to keep your records in any particular way; however, if you have more than one business, you should keep a complete and separate set of books and records for each business.

Travel expenses. You are required to support your expenses for travel in connection with your business, including local travel, gifts, entertainment, and the business use of certain ***listed property,*** with adequate records or sufficient evidence to prove your own statements. Listed property includes all passenger automobiles, entertainment, amusement or recreation type property, and computer equipment. For more information on listed property, see Publication 534, *Depreciation.* Adequate records include account books, diaries, trip sheets, or similar items.

Records that are written at or near the time you have the expenses are generally considered as adequate evidence. Oral statements or written records reconstructed much later cannot be relied on to support your expenses.

See Publication 463, *Travel, Entertainment, and Gift Expenses,* and Publication 917, *Business Use of a Car,* for more information.

Setting Up Your Records

When starting a business, you should set up a system of recordkeeping that is suitable for your business. Keep in mind the taxes you will have to pay and when you will have to pay them.

Choosing an accounting method and a tax year. You should set up your books using an accounting method that clearly shows your income for the accounting period that is your tax year. See Chapters 3 and 4.

Choosing a bookkeeping system. You must decide whether to use a single- or a double-entry bookkeeping system. The single-entry system of bookkeeping is the simplest to maintain, but it may not be good for everyone. You may find the double-entry system is better because it has built-in checks and balances to assure accuracy and control.

Single-entry. The single-entry bookkeeping system is based on the income statement (profit or loss statement) and includes only your business income and expense accounts. It can be a simple and very practical system if you are just starting a small business. For tax purposes, this system records the flow of income and expenses through the use of a daily summary of cash receipts, a monthly summary of receipts, and a monthly summary of disbursements. See *Sample Record System,* in Publication 583, *Taxpayers Starting* *a Business* for an example of single-entry bookkeeping.

Double-entry. The double-entry bookkeeping system uses journals and ledgers and is based on both the income statement and the balance sheet. Transactions are first entered in a journal and then summary totals of the transactions (usually monthly) are entered in ledger accounts. Ledger accounts include income, expense, asset, liability, and net worth. Income and expense accounts are closed at the end of the annual accounting period. Asset, liability, and net worth accounts are kept on a permanent basis.

The double-entry system is self-balancing. Every journal entry is made up of both debits and credits. The sum of the debits must equal the sum of the credits in each journal entry. After the journal entries are entered in the ledger accounts, the total of the debits equals the total of the credits and the accounts are in balance.

At the end of each accounting period, financial statements may be prepared. These statements are generally the income statement and the balance sheet. The income statement reflects the current operations for the year. The balance sheet shows the financial position of the business in terms of assets, liabilities, and net worth at an exact point in time.

Recordkeeping

You should deposit ***all business receipts*** in a separate bank account. If possible, you should also make all disbursements by check. In this way both business income and business expenses will be well documented.

Write checks payable to yourself only when making withdrawals of income from your business for your own use. Avoid writing business checks payable to cash. This will help you identify which disbursements are for business and which are personal.

If you must write a check payable to cash (or to yourself in order to get the cash) to pay a business expense, include the receipt for the cash payment in your records. If you cannot get a receipt for a cash payment, put a statement in your records at the time of the transaction to explain the payment.

You should establish a petty cash fund for small expenses. All business expenses paid by cash should be supported by documents showing their business purpose.

Support your entries. Sales slips, invoices, canceled checks, paid bills, duplicate deposit slips, and any other documents that explain and support entries made in your books should be filed in an orderly manner and stored in a safe place. Memorandums or sketchy records that approximate income, deductions, or other items affecting your tax liability will not be considered adequate.

Classify your accounts. Classify your accounts by separating them into five groups: income, expenses, assets, liabilities, and equity (net worth). For your assets, you should record the date of acquisition, cost or other original basis, depreciation, depletion, and anything else affecting their basis.

Retaining your records. You must retain (keep) the books and records of your business available at all times for inspection by the Internal Revenue Service (IRS). The records must be kept as long as they may be needed in the administration of any Internal Revenue law.

Keep records supporting items reported on a tax return until the period of limitations for that return runs out. Usually, this is the later of:

1) 3 years after the date your return is due or filed, or
2) 2 years after the date the tax was paid.

However, you should keep some records indefinitely. For example, if you adopt the last-in first-out (LIFO) method of valuing your inventory or change your accounting method, records supporting these decisions may be needed for an indefinite time.

Keep records that support your cost basis in property for as long as they are needed to figure the correct cost basis of your original or replacement property (including capital improvements).

Keep copies of your tax returns. They will help you in preparing future tax returns and in making computations if you later file a claim for refund. They may also be helpful to the executor or administrator of your estate or to the IRS if your original return is not available.

Microfilm. Microfilm and microfiche reproductions of general books of accounts, such as cash books, journals, voucher registers, and ledgers, are accepted for recordkeeping purposes if they comply with Revenue Procedure 81–46, 1981–2 C.B. 621. If your micrographic system does not meet the requirements of Revenue Procedure 81–46, you may be subject to penalties.

Computerized systems. If you maintain your records with an automated data processing system, you must be able to produce from that system legible records that will provide the necessary information to determine your correct tax liability.

In addition, you must keep all machine-sensible records along with a complete description of the computerized portion of your accounting system. This documentation must be sufficiently detailed to show the applications being performed, the procedures used in each application, and the controls used to ensure accurate and reliable processing. These records must be retained for as long as they may be material in the administration of any Internal Revenue law.

See Revenue Procedure 86–19, 1986–1 C.B. 558 for further information.

Effective Records

Good records are needed for efficient management, applying for credit, and to support all items of income and expense reported on your tax return. The following suggestions are provided to help you maintain good records and show you some ways in which they may help you to operate your business.

Identify source of income. The money or property you receive can come from many sources. Your records should identify the source of your income so you can show if an income item is taxable or nontaxable.

Maintain a record of deductible expenses. Expenses may be forgotten when you prepare your tax return unless you record them when they occur. You should also retain the invoice, paid receipt, or canceled check that supports the item of expense in a safe, well-organized file.

Figure depreciation deduction. You should note in a permanent record all business assets you can depreciate. Depreciation is the name given to recovering on your tax return the cost of your business property through periodic tax deductions. Without a record of the cost and other information on your business assets, you cannot figure your depreciation deductions. If you sell your assets, make capital improvements to them, or they become fully depreciated, only a permanent record will show how much of their cost you have not recovered. For more information, see Chapters 5 and 12.

Figure your earnings for self-employment tax purposes. The self-employment tax is part of the system for providing social security coverage for people who work for themselves. Your social security benefits that you will receive when you retire, become disabled, or that will be paid to your family in case of your death, depend on how much you contributed to your social security account based on your net earnings. Your records should show how much of your earnings are subject to self-employment tax. See Chapter 32.

Support items reported on your tax returns. If any of your tax returns are examined by the IRS, you may be asked to explain and support the items reported. A complete set of records will speed up the examination. Adequate and complete records are always supported by sales slips, invoices, receipts, bank deposit slips, canceled checks, and other documents.

Records of Employers

You must keep all your records on employment taxes (income tax withholding, social security, and federal unemployment tax) for at least 4 years after the due date of the return or after the date the tax is paid, whichever is later. In addition to the following items required for each specific kind of employment tax, your records should also contain your employer identification number, copies of the returns you have filed, and the dates and amounts of deposits you made.

Income tax withholding. The specific records you must keep for income tax withholding are:

1) Each employee's name, address, and social security number.
2) The total amount and date of each wage payment and the period of time the payment covers.
3) For each wage payment, the amount subject to withholding.
4) The amount of withholding tax collected on each payment and the date it was collected.
5) If the taxable amount is less than the total payment, the reason why it is less.
6) Copies of any statements furnished by employees relating to nonresident alien status, residence in Puerto Rico or the Virgin Islands, or residence or physical presence in a foreign country.
7) The fair market value and date of each payment of noncash compensation made to a retail commission salesperson, if no income tax was withheld.
8) For accident or health plans, information about the amount of each payment.
9) The withholding allowance certificates (Form W–4) filed by each employee.
10) Any agreement between you and the employee for the voluntary withholding of additional amounts of tax.
11) The dates in each calendar quarter on which any employee worked for you, not in

the course of your trade or business, and the amount paid for that work.

12) Copies of statements given to you by employees reporting tips received in their work, unless the information shown on the statements appears in another item on this list.
13) Requests by employees to have their withheld tax figured on the basis of their individual cumulative wages.
14) The Forms W-5, *Earned Income Credit Advance Payment Certificate,* of your employees who are eligible for the earned income credit and who wish to receive their payment in advance rather than when they file their income tax returns.

An employee's earnings ledger, which you can buy at most office supply stores, normally has space for the information required in items (1) to (4).

Social security taxes. You must also maintain the following information in your records on the social security (FICA) taxes of your employees:

1) The amount of each wage payment subject to FICA tax.
2) The amount of FICA tax collected for each payment and the date collected.
3) If the total wage payment and the taxable amount differ, the reason why they do.

Federal Unemployment Tax Act. The Federal Unemployment Tax Act (FUTA) requires you to maintain the following information in your records:

1) The total amount paid to your employees during the calendar year.
2) The amount of compensation subject to the unemployment tax.
3) The amount you paid into the state unemployment fund.
4) Any other information required to be shown on Form 940 (or Form 940-EZ), *Employer's Annual Federal Unemployment (FUTA) Tax Return.*

For information on the employment taxes you may have to pay, see Chapter 33.

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3. Accounting Periods

Every taxpayer (business or individual) must figure taxable income and file a tax return on the basis of an annual accounting period. The term "tax year" is the annual accounting period you use for keeping your records and reporting your income and expenses. The accounting periods you can use are:

1) A calendar year, or
2) A fiscal year.

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

The due date for individuals and partnerships is the 15th day of the 4th month after the end of the tax year. Individuals include sole proprietors, partners, and S corporation shareholders. The due date for filing returns for corporations and S corporations is the 15th day of the 3rd month after the end of the tax year. If the 15th day of the month falls on a Saturday, Sunday, or legal holiday, the due date is the next day that is not a Saturday, Sunday, or legal holiday.

This chapter discusses: the calendar tax year; the fiscal tax year (including a period of 52 or 53 weeks); the short tax year including change in accounting periods; improper tax years; accounting period restrictions that apply to partnerships, S corporations, and personal service corporations; and special situations that apply to corporations.

Note. Employment taxes are figured on a calendar year basis. You must use the calendar quarter for withheld income tax and social security tax. You must use the calendar year for federal unemployment tax. Employment taxes are discussed in Chapter 33.

Tax Year

Your regular accounting period is either a calendar tax year or a fiscal tax year.

Calendar Tax Year

If you adopt the calendar year for your annual accounting period, you must maintain your books and records and report your income and expenses for the period from January 1 through December 31 of each year.

If you filed your first return using the calendar tax year, and you later begin business as a sole proprietor, become a partner in a partnership, or a shareholder in an S corporation, you must continue to use the calendar tax year unless you get permission to change. See *Change in Accounting Period,* later. You must report your income from all sources, including your sole proprietorship, salaries, partnership income, and dividends, using the same tax year.

You must adopt the calendar tax year if:

1) You do not keep adequate records,
2) You have no annual accounting period, or
3) Your present tax year does not qualify as a fiscal year.

Fiscal Tax Year

A regular fiscal tax year is 12 consecutive months ending on the last day of any month except December. A 52–53 week year is a fiscal tax year that varies from 52 to 53 weeks.

If you adopt a fiscal tax year, you must maintain your books and records and report your income and expenses using the same tax year.

52–53 Week Tax Year

You can use a 52–53 week tax year if you keep your books and records, and report your income on that basis. This is a fiscal year that:

1) Varies from 52 to 53 weeks,
2) Always ends on the same day of the week, and
3) Always ends on:
   a) The date that day last falls in a particular calendar month, or
   b) The date the day falls nearest to the last day of the particular calendar month.

For example, if you elect a tax year that always ends on the last Monday in March, then for the year ending in 1991, your tax year will end on March 25, 1991. If you elected a tax year ending on the Monday nearest to the end of March, then for the tax year ending in 1991, your tax year will end on April 1, 1991.

You make the election by filing your tax return for the 52–53 week year and attaching to it a statement showing:

1) The day of the week on which the tax year will always end,
2) Whether it will end on the last such day of the week in the calendar month or on the date such day of the week occurs nearest the end of the month, and
3) The month in which or with reference to which the tax year will end.

Change to a 52–53 week tax year. You may change to a 52–53 week year that ends with reference to the end of the same month with which your present tax year ends, without first getting permission from the IRS. You must attach the statement, discussed earlier, to the tax return for the year for which the election is made.

Example. If you now use a calendar year and want to change to a 52–53 week year ending on the Friday closest to December 31, prior approval is not needed. You make the election to change by filing the statement described above with your return.

Approval required. If you change to a 52–53 week tax year that ends with reference to the end of a month that is not the same month in which your old tax year ended, you must first get approval from the IRS, as explained later.

For example, if you use a calendar year and want to change to a 52–53 week year ending on the Saturday nearest to the end of November, you must first get approval from the IRS.

To change from a 52–53 week year to any other tax year, including another 52–53 week year, you must first get approval from the IRS.

Short Tax Year

A short tax year is a tax year of less than 12 months. There are two situations that can result in a short tax year. The first occurs when you (as a taxable entity) are not in existence for an entire tax year. The second occurs when you change your accounting period. Each situation results in a different way of figuring tax for the short tax year.

Not in Existence Entire Year

A tax return is required for the short period during which you were in existence. Requirements for filing the return and paying the tax generally are the same as if the return were for a full tax year of 12 months that ended on the last day of the short tax year.

Example 1. Corporation X came into existence on July 2, 1990. It elected the calendar year for its accounting period. Corporation X must file its return by March 15, 1991. The return covers the period July 2, 1990, through December 31, 1990.

Example 2. A calendar year corporation dissolved on July 26, 1991. It must file its final return by October 15, 1991, for the period January 1 through July 26, 1991.

Example 3. Partnership YZ formed on September 5, 1990, and elected to use a fiscal year ending November 30. Partnership YZ is required to file its return by March 15, 1991.

Death of taxpayer. When an individual dies, a tax return must be filed for the decedent by the 15th day of the 4th month after the close of the individual's regular tax year.

Example. Agnes Jones was a single, calendar year taxpayer. She died on March 6, 1990. Her last tax return for the period January 1 through March 6, 1990, must be filed by April 15, 1991.

Change in Accounting Period

If you change your accounting period, you figure your tax for the short tax year by placing your taxable income for the short period on an annual basis. This computation, and other rules regarding a change in accounting period are explained in Publication 538, *Accounting Periods and Methods.*

IRS approval. You must, with certain exceptions, get approval from the IRS to change your tax year. To get this approval, you must file Form 1128, *Application to Adopt, Change or Retain a Tax Year,* and enclose the user fee of $200. This form must be filed by the 15th day of the 2nd month after the close of the short tax year. This short tax year begins on the first day after the end of your present tax year and ends on the day before the first day of your new tax year.

Example. You use a calendar tax year and, in 1990, you want to change to a fiscal year ending October 31. You must file Form 1128 by December 17, 1990

Extension to file. In some cases, you may be able to get an extension of time to change your tax year. See the discussion in Publication 538, *Extension of time to file application,* under *Change in Accounting Method.*

Husband and wife. A husband and wife who have different tax years may not file a joint return. If the husband and wife want the same tax year so they can file a joint return, the method of changing a tax year depends on whether or not they are newly married. See Publication 538 for detailed information.

Improper tax year. If you begin your business on a date other than the first day of a calendar month and end it exactly 12 months from the date it began and this ending date is other than the last day of the month, you have not satisfied the requirements for establishing a calendar year or a fiscal year. Nor does the adoption of an accounting period ending exactly 12 months from the date your business began satisfy the requirements for a 52–53 week tax year. Because you have not satisfied the requirements for either a calendar or a fiscal year, you have adopted an improper tax year. You must either file an amended income tax return on the basis of a calendar year, or if you want to use a tax year other than the calendar year, you must get approval from the IRS to change your tax year.

Amended return. To file an amended return to correct an improper tax year, you must attach a completed Form 1128 to your amended income tax return that is filed on a calendar year basis. Put "FILED UNDER REV. PROC. 85–15," at the top of your Form 1128. The form and your amended return should be filed with the service center where you filed your original return.

Partnerships, S Corporations, and Personal Service Corporations

Generally, partnerships, S corporations, and personal service corporations must use "required tax years." The required tax year does not have to be used if the partnership, S corporation, or personal service corporation establishes a business purpose for a different period, or makes a ***section 444 election,*** explained later.

Partnerships

A partnership is required to conform its tax year to its partners' tax years in the following way:

1) If one or more partners own a majority interest (more than a 50% interest in partnership profits and capital), the partnership must adopt the tax year of those partners.
2) If there are no partners who own a majority interest, or if the majority interest partners do not have the same tax year, the partnership is required to change to the tax year of its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
3) If neither (1) nor (2) applies, the partnership is required to use a tax year that results in the least aggregate deferral of income to the partners.

For more information about the required year for partnerships, see Publication 538. For general information on partnerships, see Chapter 28.

S Corporations

A small business corporation can elect to be an S corporation. All S corporations, regardless of when they became S corporations, are required to use a calendar tax year, or any other tax year for which the corporation establishes a business purpose for a different period, or makes a section 444 election. For general information on S corporations, see Chapter 30.

Personal Service Corporations

Personal service corporations are required to use a calendar tax year unless they can establish a business purpose for a different period, or make a section 444 election. For this purpose, a personal service corporation generally is a corporation in which the principal activity is the performance of personal services that are substantially performed by employee-owners.

Performance of personal services. For this purpose, any activity that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or certain consulting, is considered to be the performance of personal services.

For additional information about a personal service corporation's tax years, see Publication 538.

Section 444 Election

Partnerships, S corporations, and personal service corporations may elect to use a tax year that is different from the required tax year. Certain restrictions apply to this election which is called a section 444 election. This election does not apply to any partnership, S corporation, or personal service corporation that establishes a business purpose for a different period.

A partnership, S corporation, or personal service corporation may make a section 444 election if:

1) It is not a member of a tiered structure (see section 1.444–2T of the Income Tax Regulations),
2) It has not previously had a section 444 election in effect, and
3) It elects a year that meets the deferral period requirement.

Deferral period. Generally, a partnership, S corporation, or personal service corporation may make a section 444 election only if the tax year elected results in a deferral period of 3 months or less.

An election to change a tax year will be allowed only if the deferral period of the elected tax year is not longer than the shorter of:

1) Three months, or
2) The deferral period of the tax year being changed.

For a partnership, S corporation, or personal service corporation that wants to ***adopt or change*** its tax year, by making a section 444 election, the deferral period is the number of months between the end of the elected tax year and the close of the required tax year. If the current tax year is the required tax year, the deferral period is zero.

Example 1. BD partnership uses a calendar tax year which is also its required tax year. Because BD's deferral period is zero, BD is not able to make a section 444 election.

Example 2. E, a newly formed partnership, began operations on December 1, 1990. E is owned by calendar year partners. E wants to make a section 444 election to adopt a September 30 tax year. E's deferral period for the tax year beginning December 1, 1990, is 3 months (September 30, to December 31, 1991).

Making the election. You make a section 444 election by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year,* with the Internal Revenue Service Center where you normally file your returns. Form 8716 must be filed by the earlier of:

1) The 15th day of the fifth month following the month that includes the first day of the tax year for which the election will be effective, or
2) The due date (without regard to extensions) of the income tax return resulting from the section 444 election.

In addition, you must attach a copy of Form 8716 to your Form 1065 or appropriate Form 1120 for the first tax year for which the election is made.

Example 1. AB, a partnership, began operations on September 11, 1990, and is qualified to make a section 444 election to use a September 30 tax year for its tax year beginning September 11, 1990. AB must file Form 8716 by January 15, 1991, which is the due date of the partnership's tax return for the period September 11, 1990, to September 30, 1990.

Example 2. The facts are the same as in Example (1) except that AB began operations on October 20, 1990. AB must file Form 8716 by March 15, 1991, the 15th day of the fifth month following the month that includes the first day of the tax year for which the election will first be effective.

Example 3. B is a corporation that first becomes a personal service corporation for its tax year beginning September 1, 1990. B qualifies to make a section 444 election to use a September 30 tax year for its tax year beginning September 1, 1990. B must file Form 8716 by December 15, 1990, the due date of the income tax return for the short period September 1 to September 30, 1990.

Ending the election. The section 444 election remains in effect until it is terminated. The election ends when the partnership, S corporation, or personal service corporation:

1) Changes to its required tax year,
2) Liquidates,
3) Willfully fails to comply with the required payments or distributions, or
4) Becomes a member of a tiered structure.

The election will also end if an S corporation's S election is terminated, or a personal service corporation ceases to be a personal service corporation. However, if a personal service corporation that has a section 444 election in effect elects to be an S corporation, the S corporation may continue the election of the personal service corporation. Or, if an S corporation terminates its S election and immediately becomes a personal service corporation, the personal service corporation may continue the section 444 election of the S corporation.

If the election is terminated, another section 444 election cannot be made for any tax year.

Required payment for partnerships and S corporations. Partnerships and S corporations must make a "required payment" for any tax year that the section 444 election is in effect and the required payment amount is more than $500. You also must pay if you had a required payment for any prior tax year that was more than $500 and you have a liability of any amount for this applicable year. Any tax year that a section 444 election is in effect, including the first year, is called an "applicable election year." This required payment represents the value of the tax deferral that the owners receive through the use of a tax year different from the required tax year.

Report the required payment on Form 8752, *Required Payment or Refund Under Section 7519.* If the required payment is more than $500 (or the required payment for any prior tax year was more than $500), pay it when Form 8752 is filed. If the required payment is $500 or less, and no payment was required in a prior year, no payment is required, but Form 8752 must be filed showing a zero amount.

When to file. Form 8752 must be filed and the required payment made (or zero amount reported) by May 15 of the calendar year following the calendar year in which the applicable election year begins. For example, if a partnership's applicable election year begins July 1, 1990, Form 8752 must be filed by May 15, 1991.

Personal service corporations. If a personal service corporation makes a section 444 election, it must distribute certain amounts to employee-owners by December 31 of each applicable election year. If it fails to make these distributions, it may be required to defer certain deductions for amounts paid to owner-employees. The amount deferred is treated as paid or incurred in the following tax year.

For information on the minimum distribution, see Schedule H, *Section 280H Limitations for a Personal Service Corporation (PSC),* of Form 8716.

Expeditious Approval

A procedure is provided whereby a partnership, S corporation, or personal service corporation may expeditiously obtain approval to change its tax year. For information on this procedure, see Publication 538.

Corporations

A new corporation establishes its tax year when it files its first income tax return. An S corporation or a personal service corporation must use the required tax year rules, discussed earlier, to establish its tax year. A newly reactivated corporation, which has been inactive for a number of years, is treated as a new taxpayer for the purpose of adopting a tax year.

Change in Tax Year

A corporation (other than an S corporation or a personal service corporation) may change its tax year without first getting the approval of the IRS if the following conditions are met:

1) It must not have changed its tax year within the 10 calendar years ending with the calendar year in which the short tax year resulting from the change begins,
2) Its short tax year must not be a tax year in which it has a net operating loss,
3) Its taxable income for the short tax year must be (when annualized) 80% or more of its taxable income for the tax year before the short tax year, and
4) It must not try to become an S corporation for the tax year that would immediately follow the short tax year required to effect the change.

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4. Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. The term "accounting method" includes not only the overall method of accounting you use, but also the accounting treatment you use for any item.

You choose your accounting method when you file your first tax return. After that, if you want to change your accounting method, you must first get permission from the IRS. See *Change in Accounting Method,* later.

No single accounting method is required of all taxpayers. You must use a system that clearly shows your income and expenses and you must maintain records that will enable you to file a correct return. In addition to your permanent books of account, you must keep any other records necessary to support the entries on your books and tax returns.

You must use the same method from year to year and figure your taxable income following the accounting method you use to keep your books. This method must clearly show your income and expenses. Any accounting method that shows the consistent use of generally accepted accounting principles for your trade or business generally is considered to clearly show income. An accounting method clearly shows income only if all items of gross income and all expenses are treated the same from year to year.

If you do not regularly use an accounting method that clearly shows your income, your income will be figured under the method that, in the opinion of the IRS, clearly shows your income.

Methods you may use. Generally, you may figure your taxable income under any of the following accounting methods:

1) Cash method,
2) Accrual method,
3) Special methods of accounting for certain items of income and expenses, and
4) Combination (hybrid) method using elements of (1), (2), or (3).

The cash and accrual methods of accounting are explained later.

Special methods. There are special methods of accounting for certain items of income or expense such as:

Depreciation, discussed in Chapter 12,

Amortization and depletion, discussed in Chapter 13,

Deduction for bad debts, discussed in Chapter 14, and

Installment sales, discussed in Chapter 24.

Combination (hybrid) method. Any combination of cash, accrual, and special methods of accounting can be used if the combination clearly shows income and is consistently used. You may specifically use the accrual method for purchases and sales, and the cash method for all items of income and expenses. The following restrictions do apply:

1) If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
2) If you use the accrual method for reporting your expenses, you must use the accrual method for figuring your income.

Any combination that includes the cash method is treated as the cash method, subject to the limitations applied to this method.

Business and personal items. You may account for business and personal items under different accounting methods. Thus, you may figure the income from your business under an accrual method even though you use the cash method to figure personal items.

Two or more businesses. If you operate more than one business, you may use a different accounting method for each separate and distinct business if the method you use for each clearly shows your income. For example, if you operate a personal service business and a manufacturing business, you may use the cash method for the personal service business but you must use the accrual method for the manufacturing business.

No business will be considered separate and distinct if you do not keep a complete and separable set of books and records for that business.

Cash Method

The cash method of accounting is used by most individuals and many small businesses with no inventories. However, if inventories are necessary in accounting for your income, you must use the accrual method for your sales and purchases. If you are not required to keep inventories, you usually will use the cash method. However, see *Limits on Use of Cash Method*, later.

Income

With the cash method, you include in your gross income all items of income you actually or constructively receive during the year. You must include property and services you receive in your income at their fair market value.

Constructive receipt. You have constructive receipt of income when an amount is credited to your account or made available to you without restriction. You do not need to have possession of it. If you authorize someone to be your agent and receive income for you, you are treated as having received it when your agent receives it.

Example 1. You have interest credited to your bank account in December 1990. You must include it in your gross income for 1990 and not for 1991 when you withdraw it or enter it in your passbook.

Example 2. You have interest coupons that mature and are payable in 1990, but you do not cash them until 1991. You must include them in income for 1990. You must include this matured interest in your gross income even though you later exchange the coupons for other property instead of cashing them.

Delaying receipt of income. You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying the tax on the income. You must report the income in the year the property is made available to you without restriction.

Expenses

Usually, you must deduct expenses in the tax year in which you actually pay them. However, expenses you pay in advance can be deducted only in the year to which they apply. In addition, if the uniform capitalization rules apply (see Chapter 8), you may have to capitalize certain costs.

Example. You are a calendar year taxpayer and you pay $1,000 for a business insurance policy that is effective on July 1, 1990, for a one-year period. You may deduct $500 in 1990, and $500 in 1991.

Limits on Use of Cash Method

The cash method, including any combination of methods that include the cash method, cannot be used by the following entities:

1) Corporations (other than S corporations),
2) Partnerships having a corporation (other than an S corporation) as a partner, and
3) Tax shelters.

Exceptions. An exception allows farming businesses (including the raising, harvesting, or growing of trees), qualified personal service corporations, and entities with average annual gross receipts of $5,000,000 or less to continue using the cash method. However, these exceptions do not apply to tax shelters. See Publication 538, *Accounting Periods and Methods*, for more information.

The Accrual Method

Under the accrual method of accounting, income generally is reported in the year earned, and expenses are deducted or capitalized in the year incurred. The purpose of the accrual method of accounting is to match your income and your expenses in the correct year.

Income

All items of income are generally included in your gross income when you earn them, even though you may receive payment in another tax year. All events that fix your right to receive the income must have happened, and you must be able to figure the amount with reasonable accuracy.

Example. You are a calendar year taxpayer. You sold a television on November 28, 1990. The television was delivered to the customer in December, but you did not receive payment until February 1991. You must include the amount of the sale in your income for 1990 because you earned the income and delivered the property in 1990.

Advance income. Special rules dealing with an accrual method of accounting for advance payments to you are discussed in Chapter 7 under *Prepaid Income*.

Estimating income. When you include an amount in gross income on the basis of a reasonable estimate, and you later determine the exact amount, the difference, if any, is taken into account in the year in which the determination is made.

Change in payment schedule for services. If you contract to perform services for a basic rate, you must include the basic rate in your income as it accrues. You must accrue the basic rate even if, as a matter of convenience, you agree to receive payments at a lower rate until you complete your services at which time you will receive the difference between the basic rate and the amount actually paid to you.

Accounts receivable for services. You may not have to accrue all of your accounts receivable if, based on your experience, you will not collect all of these accounts. This is called the *nonaccrual-experience method*. See section 1.448–2T(b) of the Income Tax Regulations.

Expenses

You deduct or capitalize business expenses when you become liable for them, whether or not you pay them in the same year. All events that set the amount of the liability must have happened, and you must be able to figure the amount with reasonable accuracy.

Economic performance rule. Generally, you cannot deduct business expenses until economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided or as the property is used. If your expense is for property or services that you provide to others, economic performance occurs as you provide the property or services. An exception allows certain recurring expenses to be treated as incurred during a tax year even though economic performance has not occurred.

Example. You are a calendar year taxpayer and in December 1990 you buy office supplies. You received the supplies and are billed for them in December, but you pay for the supplies in January 1991. You can deduct the expense in 1990 because (1) all events that set the amount of liability and (2) economic performance occurred in that year.

Your office supplies may qualify as a recurring expense. In that case, you may be able to deduct the expense in 1990 even if economic performance (delivery of the supplies to you) did not occur until 1991. See Publication 538 for more information on the economic performance requirement.

Inventories. Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If inventories are necessary to show income correctly, only the accrual accounting method can be used for purchases and sales. Inventories are discussed in Chapter 6.

Special Rules for Related Persons

You cannot deduct business expenses and interest owed to a related cash basis person ***until*** you make the payment and the corresponding amount is includible in the gross income of the related person. Determine the relationship for this rule as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if your relationship with the person ends before the expenses or interest is includable in the gross income of that person.

Related persons. For the purpose of applying this rule, the following are related persons:

1) Members of the immediate family, including only brothers and sisters (either whole or half), husband and wife, ancestors, and lineal descendants.
2) Two corporations that are members of the same controlled group.
3) The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts if the same person is the grantor of both trusts.
4) Certain educational and charitable organizations and a person (if an individual, including the members of the individual's family) who, directly or indirectly, controls the organization.
5) An individual and a corporation of which more than 50% of the value of the outstanding stock is owned, directly or indirectly, by or for that individual.
6) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust.
7) The grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
8) Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
9) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
10) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

Indirect ownership of stock. To decide whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply:

1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries,
2) An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family (as defined in item (1) under *Related persons*),
3) Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner, and
4) Stock constructively owned by a person under rule (1), for applying rules (1), (2), or (3), is treated as actually owned by that person. But stock constructively owned by an individual under rules (2) or (3) will not be treated as owned by the individual for applying either rule (2) or (3) to make another person the constructive owner of that stock.

Reallocation of income and deductions. Where it is necessary to clearly show income or to prevent evasion of taxes, the IRS may reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

Gains and losses. Gains and losses on sales or exchanges between ***related parties*** are discussed in Chapter 22. For information on losses from sales or exchanges of property between partners and partnerships, see Chapter 28.

Change in Accounting Method

When you file your first return, you may, without consent from the IRS, choose any appropriate accounting method. The method you choose must clearly show your income and this same method must be used from year to year.

After your first return is filed, if you want to change your accounting method, you must first get consent from the IRS. This is necessary to notify the IRS that a change is being made and to prevent you from gaining an unlawful tax advantage.

The IRS will consider the need for consistency in the accounting area against your reason for wanting to change your accounting method when the method from which you are changing clearly shows your income.

The absence of IRS consent to a change in your method of accounting because you did not request a change (such as a change from an improper method of accounting to a proper method of accounting) does not prevent the IRS from imposing any penalty or addition to tax, nor diminish the amount of the penalty or the addition to tax.

A change in your accounting method includes a change not only in your overall system of accounting but also in the treatment of any material item. Some examples of changes that ***require*** consent are:

1) A change from the cash method to the accrual method or vice versa (unless you must change to the accrual method and you make the change automatically),
2) A change in the method or basis used to value inventories, and
3) A change in the method of figuring depreciation (except certain changes to the straight line method as explained in Chapter 12).

Automatic change to accrual method. If you must discontinue the use of the cash method and desire to change to the accrual method, discussed earlier under *Limits on Use of Cash Method*, such change is treated as a change that does not require consent from the IRS.

Form 3115. Even though this change to the overall accrual method is regarded as automatic, you must complete and file Form 3115 with the user fee of $500, no later than the due date (including extensions) for filing your income tax return.

Accounting change information. For information about the procedures to change your accounting method, see Publication 538.

Part II
Business Assets

Whether you are starting a new business or are continuing a going one, you probably need to acquire property to use in your business. The cost of this property becomes part of the capital investment in your business. This Part discusses the kinds of costs that must be capitalized and how to figure the basis of your business assets.

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5. Capital Expenses

A business typically has many different kinds of costs during the year. Some of these costs are counted as part of your investment in your business. They must be "capitalized" rather than deducted, and are known as ***capital expenditures or capital expenses.*** This chapter and the next discuss the treatment of capital expenses.

Capital expenses must be distinguished from the other costs your business has. Most other costs can be taken into account when figuring the net income or loss of your business, either as part of the cost of goods sold or as ordinary business expenses.

Cost of goods sold. If your business manufactures products or purchases them for resale, some of your costs are for the products you sell. These costs are used to figure the cost of goods you sold during the year. Cost of goods sold is subtracted from total sales to figure gross profit for the year. See the chapters in Part III for more information on gross profit and the cost of goods sold. See Chapter 8 for a discussion of the uniform capitalization rules that apply to property produced for sale or purchased for resale.

Business expenses. Most of the other operating costs your business has can be deducted from gross profit when figuring income or loss for the year. These operating costs are known as business expenses. Some of the business expenses that are deductible are advertising, office supplies, insurance premiums, employee wages, utilities, rent, and property taxes. See the chapters in Part IV for information on deducting business expenses, including the limits on what can be deducted. Also, see Chapter 8 for a discussion of the uniform capitalization rules that apply to property produced for sale or purchased for resale.

Kinds of capital expenses. Generally, three kinds of costs must be capitalized:

1) ***Going into business.*** The costs of getting started in business, before you actually begin business operations, are all capital expenses. This may include the cost of such things as advertising, travel, utilities, repairs and employees' wages. These are often the same kind of expenses that you could deduct if you had them after you opened for business. The costs of going into business are discussed later in this chapter.
2) ***Business assets.*** The cost of any asset that you will use in your business for more than one year is a capital expense. There are many different kinds of business assets—for example, land, buildings, machinery, trucks, books, furniture, patents, and franchise rights. Business assets are discussed later in this chapter.
3) ***Improvements.*** The costs of making improvements to a business asset are also capital expenses, if the improvements add to the value of the asset, appreciably lengthen the time you can use it, or adapt it to a different use. However, normal repair costs are deducted as business expenses and not capitalized. Ordinarily, the cost of the improvement is added to the basis of the improved property. The cost of the improvement is recovered through annual depreciation deductions. See Chapter 12.

   Examples of improvements are new electric wiring, a new roof, new floor, new plumbing, bricking up windows to strengthen a wall, lighting improvements, asbestos abatement and abatement of hazardous substances.

Restoration plan. The cost of reconditioning, improving, or altering your property as part of a general restoration plan to make it suitable for your business must be capitalized. This applies even if some of the work would by itself be classified as repairs. See the discussion of replacements, later.

Basis. When you make a capital expense, your cost becomes a part of "basis." Basis is a way of measuring your investment in your business and its assets for tax purposes. It is used in many ways—to figure gain or loss on a sale, to figure the amount of a casualty loss, to figure depreciation deductions, etc.

Your original basis in an asset is the amount you must spend to acquire it. But even if it does not cost you anything to acquire a business asset—for example, if you inherit it or get it as a gift—you will still have a basis in the asset. While you own the asset, various events may take place that will change your basis in the property. Some events, such as improvements or additions, increase basis. Others, such as casualty losses or depreciation deductions, decrease basis.

For more information on figuring basis, see Chapter 6.

Recovery. Although you generally cannot directly deduct a capital expense, you can often "recover" your cost—subtract it from income—one part at a time over a number of years. This is done by deducting a percentage of basis each year under one of the following methods:

1) ***Depreciation.*** Depreciation is used to recover capital expenses for most tangible business assets.
2) ***Amortization.*** Amortization is used to recover only certain kinds of capital expenses, such as some research costs, business start-up costs, and the cost of pollution control facilities.
3) ***Depletion.*** Depletion is used to recover the cost of an economic interest in timber, minerals, and other natural resources.

You can choose to deduct in one tax year a limited amount of what you spend to acquire certain tangible property for use in a trade or business instead of treating this amount as a capital expense. For 1990 the maximum amount you can deduct is $10,000. See *Section 179 Deduction,* in Chapter 12.

Depreciation is discussed in Chapter 12. Amortization and depletion are covered in Chapter 13.

If you do not completely recover a capital expense through depreciation, amortization, or depletion, you can usually recover the balance when you sell or otherwise give up ownership of your business assets. Basis is subtracted from the amount you realize on a sale to figure gain or loss (see Chapter 21). Basis is also the starting point for figuring gain or loss if a business asset is stolen or destroyed (see Chapter 25). If you abandon the asset, you also use basis to figure your loss (see *Dispositions* in Publication 534, *Depreciation*).

Replacements. Like the cost of improvements, you may not deduct the cost of a replacement that stops deterioration and adds to the life of your property. It should be capitalized and depreciated.

Amounts you pay to replace parts of a machine that only keep it in a normal operating condition are treated like repairs and are deductible business expenses. However, if your equipment has a major overhaul, the expense is capitalized and depreciated.

Capital expenses or deductible expenses. To help you distinguish between capital expenses and deductible expenses, several different items are discussed below.

Business motor vehicles. The cost of a motor vehicle you buy to use in your business is usually capitalized. You can recover its cost through annual deductions for depreciation.

There are dollar limits on the amount of depreciation you may claim each year for passenger automobiles you place in service for your business. See Chapter 12.

Repairs you make to your business vehicle are deductible. However, amounts you pay for reconditioning and overhaul of business vehicles are capital expenses.

Roads and driveways. The cost of building a private road on your business property and the cost of replacing a gravel driveway with a concrete one are capital expenses which you may be able to depreciate. The cost of maintaining a private road on your business property is deductible as an ordinary and necessary business expense.

Tools. Unless the uniform capitalization rules apply, amounts spent for tools used in your business are deductible expenses if the tools wear out and are thrown away within one year from the date of purchase.

Machinery. Unless the uniform capitalization rules apply, the cost of replacing short-lived parts of a machine to keep it in good working condition and not to add to its life is deductible as an ordinary and necessary expense.

Heating equipment. The cost of changing from one heating system to another is a capital expense and not a deductible expense.

Business Assets

A business usually owns property that it uses, directly or indirectly, to earn its income. Property that is used in this way is a business asset. Business assets are classified as tangible or intangible, real or personal.

All the costs of getting a business asset that is ordinarily used for more than one year are capital expenses. This includes the cost of freight, installation, and testing. It also includes the costs of building an asset yourself. See Chapter 6.

Tangible and intangible property. A business asset may be tangible property—such as a warehouse, lathe, desk, truck, or tool—or it may be intangible property—such as a trademark, customer list, franchise, promissory note, or goodwill. Tangible property is property that can be felt or touched. Its physical features are what make it useful to you. Intangible property is property that is not tangible. Documents that are merely representations of value (such as stock certificates) or evidence of rights (such as patents) are intangible property.

Real and personal property. Tangible business assets are further classified as either real or personal property. Real property is land and anything fixed to the land—for example, fences, parking lots, buildings, or trees. Everything else is personal property—for example, furniture, office equipment, vehicles, and supplies. Components of buildings—such as air conditioning, plumbing, and furnaces—may be real or personal property, depending on state law.

Going Into Business

As you get ready to go into business, you probably will have a number of different costs. For example—

1) You may travel to look over various business possibilities, or to find customers and suppliers.
2) You may conduct market surveys, or begin to advertise your business.
3) You may retain a lawyer to help organize your business, or an accountant to set up a recordkeeping system.
4) You may begin to hire and train employees.

However, because your business has not yet started active operations, you are not allowed to deduct these kinds of costs as expenses. The costs you have in setting up a business are capital expenses. They cannot be taken either as business or as nonbusiness deductions.

The tax treatment of the costs you have to become established in business depends mainly on two factors:

1) What the costs are for, and
2) Whether or not you actually go into business.

If you buy business assets. The costs connected with acquiring a business asset become part of your basis in the asset. For example, a lawyer's fee for negotiating a lease becomes part of your basis in the lease. The cost of a land survey for real estate you plan to buy becomes a part of your basis in the property once you acquire it.

If your attempt to acquire a business asset is not successful, you can deduct, as a capital loss, the costs you had in the attempt. You can take this loss whether or not you eventually go into business.

If you fail to go into business. If your attempt to go into business is not successful, the expenses you had in trying to establish yourself in business fall into two categories:

1) The costs you had before making a decision to acquire or begin a specific business. These costs are personal and nondeductible. They include any costs incurred in the course of a general search for, or a preliminary investigation of, a business or investment possibility.
2) The costs you had in connection with your attempt to acquire or begin a specific business. These costs are capital expenses and can be deducted as a capital loss.

The costs of any assets you acquired during your unsuccessful attempt to go into business are a part of your basis in the assets. You cannot take a deduction for these costs.

If you go into business. When you go into business, all the costs you had to get your business started are treated as capital expenses and are a part of your basis in the business. Costs that were for particular assets can generally be recovered through depreciation deductions. Other expenses generally cannot be recovered until you sell or otherwise go out of business.

However, you can choose to amortize certain costs that you have in setting up your business. These costs are deducted as expenses in equal amounts over a period of 60 months or more. The costs you can amortize include:

1) Business start-up costs,
2) Organizational costs for a corporation,
3) Organizational costs for a partnership, and
4) The cost of acquiring a lease.

See Chapter 13 for more information on business start-up costs and organizational costs of a corporation or partnership. See Chapter 11 for more information on amortizing the cost of a lease.

Costs You Can Choose To Deduct or To Capitalize

There are certain costs that you can choose either to deduct or to capitalize. The choice you make depends on when it is best for you to recover your costs.

If you deduct a cost as an expense, you in effect "recover" it in full—subtract it from income—through the deduction.

If you capitalize a cost, you may be able to "recover" it through a section 179 deduction or periodic deductions for depreciation, amortization, or depletion. (See Chapters 12 and 13.) Or you may recover it when you sell the asset you bought and figure your gain or loss.

See Chapter 6, for a discussion of the uniform capitalization rules that apply to property produced for sale or use in a trade or business.

The costs that you can choose to deduct or to capitalize include:

- Certain carrying charges on property (unless the uniform capitalization rules apply)
- Research and experimental costs that are reasonable
- "Intangible" drilling and development costs for oil, gas, and geothermal wells
- Exploration costs for new mineral deposits
- Mine development costs for a new mineral deposit
- Costs of increasing the circulation of a newspaper or a periodical
- Costs of making public transportation vehicles, buildings, and other facilities more accessible.

The decision to capitalize or to deduct belongs to the business entity—the sole proprietor, partnership, corporation, estate, or trust. Individual partners, shareholders, and beneficiaries do not make the choice themselves (except for exploration costs for a new mineral deposit).

For individuals, partners, beneficiaries, and S corporation shareholders, all of the costs listed above, except carrying charges and costs of making public transportation vehicles and facilities more accessible, are items of tax preference subject to the alternative minimum tax if they are deducted.

If you decide to deduct these items over an optional write-off period, they will not be treated as tax preference items. For more information, see *Optional Write-Off* in Publication 909, *Alternative Minimum Tax for Individuals.*

Carrying charges. Carrying charges are the taxes and interest that you pay for carrying and developing real property and for carrying, transporting, and installing personal property. You can choose to capitalize certain carrying charges that otherwise would be deductible. You may deduct or elect to capitalize carrying charges only for property that is ***not*** covered by the mandatory capitalization rules.

Making the choice. You may make a separate choice to capitalize carrying charges for each project you have and for each type of carrying charge. For unimproved and unproductive real property, your choice is good for only one year. You must make a new choice each year the property remains unimproved and unproductive.

To make the choice to capitalize a carrying charge, simply write out a statement saying which charges you choose to capitalize. Attach the statement to your original tax return for the year the choice is to be effective.

See Publication 538 for information on methods of accounting.

Research and experimental costs. The cost of research and experimentation that is reasonable is generally a capital expense. However, you can choose to deduct some of these costs as a current business expense.

This choice applies to costs of research and development in the laboratory or experimental sense. It includes the cost of developing or improving a product, a formula, an invention, a plant process, an experimental or pilot model, or something similar. It also includes the cost of any research or experimental work carried on for you by someone else (such as a research institute, foundation, engineering company, or similar contractor). It does not apply to market research, management surveys, or normal product testing.

The choice you make applies to all research and development costs you have for a project.

You cannot choose to deduct some expenses for a project and capitalize others.

However, if you do not choose to deduct your research and development costs for a project, there is another choice that you can make for at least some of your costs. You can choose to treat certain research and development costs as deferred expenses and amortize them over a period of 60 months or more, beginning with the month that you first receive an economic benefit from the research. See *Research and experimental costs* in Chapter 13.

How to make the choice. To choose to currently deduct research and development costs, simply claim them as an expense deduction on your income tax return for the year in which you first have them.

If you want to make this choice after the first year, you must get the permission of the Internal Revenue Service (IRS). File Form 3315, *Application for Change in Accounting Method.*

Research credit. No matter how you treat your research and experimental costs, you may qualify for a credit on some or all of them. See instructions for Form 6765, *Credit for Increasing Research Activities (or for claiming the orphan drug credit).*

Drilling and development costs. The costs of developing oil, gas, or geothermal wells are capital expenses. They can usually be recovered through depreciation or depletion. However, you can choose to deduct certain drilling and development costs for wells located in the United States as current business deductions if you hold an operating or working interest in a parcel of land and are developing oil, gas, or geothermal wells on it. For more information, see Publication 535, *Business Expenses.*

Exploration costs. If the costs of determining the existence, location, extent, or quality of any mineral deposit lead to the development of a mine, they would normally be capital expenses. You can recover these costs through depletion as the mineral is removed from the ground. However, you can choose to deduct exploration expenses (except those for oil, gas, and geothermal wells) if you have them before the development stage begins. These costs can be deducted if they are for domestic exploration. However, foreign exploration costs cannot be deducted currently. For more information, see Publication 535.

Development costs. You may deduct costs paid or incurred during the tax year for developing a mine or any other natural deposit (other than an oil or gas well or geothermal property) located in the United States if the costs are paid or incurred after the discovery of ores or minerals in commercially marketable quantities. Or you may choose to treat the costs as deferred expenses, deductible on a ratable basis when you sell the units of produced ores or minerals benefited by the expenses. For more information, see Publication 535.

Improvements for disabled and elderly people. The cost of an improvement to a business asset is normally a capital expense. However, you can choose to deduct up to $35,000 ($15,000 for tax years beginning after November 5, 1990) of the cost of improvements that make a building, public transportation vehicle, or other facility more accessible to elderly and disabled people. For more information, see Publication 535.

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6. Basis of Assets

Basis is a way of measuring your investment in property for tax purposes. The basis of property is used in figuring gain or loss from the sale or other disposition of property. It is also used in figuring the deduction for depreciation, amortization, depletion, and casualty losses.

This chapter is divided into three sections: Cost Basis, Adjusted Basis, and Other Basis. The basis for inventories is discussed in Chapter 8.

The basis of property you buy is its cost to you. If the asset is used in a trade or business or an activity conducted for profit, many direct and indirect costs must be capitalized (added to the basis) as part of the cost basis.

Your original basis in property (whether cost or other) must be increased or decreased (adjusted) for certain events. If you make improvements to the property, this will increase your basis. If you take deductions for depreciation or casualty losses, this will reduce your basis.

Your basis in some assets cannot be determined by cost. This includes property you receive as a gift or inheritance. It also applies to property received in an involuntary exchange, and certain other circumstances. If you acquire property by inheritance, receive a gift of property, or have property transferred to you from a spouse or former spouse, see *Other Basis* in Publication 551, *Basis of Assets.*

If you sell or exchange your property, you must figure your gain or loss on the transaction. Compare the amount realized from the sale or exchange to the adjusted basis of the property you transferred. The amount realized is the money you received, plus the fair market value of any other property you received. For information on sales and exchanges, see Chapter 21.

To figure depreciation, use "unadjusted basis." For information on unadjusted basis and depreciation, see Chapter 12.

As a partner, you must know the basis of your interest in the partnership to figure your allowable deduction for partnership losses. You also must know your basis if you dispose of all or part of your interest in the partnership. For information on partnerships, see Chapter 28.

If any of your debts were canceled by a creditor, or were discharged because you became bankrupt, the basis of your assets might be affected. For more information, see Publication 908, *Bankruptcy and Other Debt Cancellation.*

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay for it in cash or in other property or services. Your cost includes amounts you pay for sales tax, freight, installation, and testing. In addition, the cost basis of real estate and business assets will include other items.

Loans with low or no interest. If you buy property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, less the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than 9% compounded semi-annually. See *Unstated Interest* in Chapter 24.

Real Property

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

Real estate taxes. If you buy real property and agree to pay certain taxes the seller owed on it, the taxes you pay are treated as part of your cost. You may not deduct them as taxes paid.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the cost of the property.

Settlement fees or closing costs. Recording fees and legal fees are some of the settlement fees or closing costs that are included in the basis of property. Some others are:

1) Abstract fees,
2) Charges for installing utility services,
3) Surveys,
4) Transfer taxes,
5) Title insurance, and
6) Any amounts the seller owes but which you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

You must reasonably allocate these fees or costs between land and improvements to figure the basis for depreciation of the improvements. Allocate the fees according to the fair market values of the land and improvements at the time of purchase. Settlement fees do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

Assumption of a mortgage. If you buy property and become liable for an existing mortgage on the property, your basis is the amount you pay for the property plus the amount to be paid on the mortgage you assume.

Example. If you buy a building for $20,000 cash and assume a mortgage of $80,000 on it, your basis is $100,000.

Constructing Assets

If you build a home or other nonbusiness property, or build business property, or have assets built for you, expenses you pay for this construction are part of your cost basis. Some of these expenses include:

1) Land,
2) Architect's fees,
3) Building permits,
4) Payments to contractors,
5) Payments for rental equipment, and
6) Inspection fees.

In addition, if you own a business and use your employees, material, and equipment to construct a business or nonbusiness asset, other expenses that are part of your cost basis include:

1) Employee compensation for work on the asset,
2) Depreciation deductions on equipment you own while it is used in the construction,

3) Operating and maintenance costs for equipment used in the construction, and
4) The cost of business supplies and materials consumed in the construction.

If you use business supplies and materials to construct an asset, or pay employees to construct an asset, you may not deduct these expenses as current business expenses. These expenses are part of your basis in the assets. You must reduce your basis by any jobs credit allowed on the wages you pay to these employees.

Business Assets

If you purchase property to be used in your business, your basis usually is its actual cost to you. However, if you construct, build, or otherwise produce property, you may be subject to the uniform capitalization rules to determine the basis of the property.

Example 1. Dale White is an independent contractor. He purchased a building to be used in his business to store his construction equipment. Dale's basis in the building is its cost to him.

Example 2. Assume the same facts as in Example 1 except instead of purchasing the building, Dale had his employees construct the building. Dale must determine his basis in the building under the uniform capitalization rules.

Uniform Capitalization Rules

You are subject to the uniform capitalization rules if you:

1) Produce real property or tangible personal property for use in a trade or business or an activity engaged in for profit,
2) Produce real property or tangible personal property for sale to customers, or
3) Acquire property for resale.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise or grow the property. Property produced for you under a contract is treated as produced by you to the extent that you make payments or otherwise incur costs in connection with the property. Tangible personal property includes films, sound recordings, video tapes, books, art work, or similar property.

Under the uniform capitalization rules, you are required to capitalize (add to the basis) direct costs and an allocable portion of most indirect costs that benefit or are incurred because of production or resale activities. This means that certain expenses you have during the year will be included in the basis of property you produce or in your inventory costs, rather than claimed as a current deduction. You will recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

Any cost which is not computed in figuring your taxable income for any tax year is not subject to the uniform capitalization rules.

The following discussion explains how certain costs are treated under the uniform capitalization rules. For more information on these rules, see the regulations under section 263A of the Internal Revenue Code, which contain descriptions of the methods that may be used to allocate costs.

Exceptions. The uniform capitalization rules do not apply to such things as:

1) Property you produce that is used for personal or nonbusiness purposes.
2) Costs paid or incurred by an individual (other than as an employee) or a qualified employee-owner of a corporation in the business of being a freelance writer, photographer, or artist.
3) Property you produce under a long-term contract.
4) Certain research and developmental expenses allowable as a deduction.
5) Costs connected with personal property acquired for resale if your average annual gross receipts do not exceed $10 million.

See *Exceptions* under *Uniform Capitalization Rules* in Publication 551, ***Basis of Assets***, for a complete list of exceptions.

Direct costs. Direct material costs and direct labor costs incurred for production or resale activities must be capitalized. All other costs are indirect costs. Direct material costs include the cost of materials that become an integral part of the asset plus the cost of materials used in the ordinary course of the activity.

Direct labor costs include the cost of labor that can be identified or associated with a particular activity. This includes all types of compensation (basic, overtime, sick, vacation, etc.) plus payroll taxes and payment to a supplemental unemployment benefit plan.

Indirect costs. Certain types of costs may directly benefit, or be incurred because of, a particular activity even though the same costs also benefit other activities. Therefore, these costs require a reasonable allocation to determine the portion attributable to each of your activities.

Indirect costs that must be capitalized for production or resale activities include, but are not limited to, amounts incurred for:

1) Repair and maintenance of equipment or facilities.
2) Utilities (heat, light, power, etc.) relating to equipment or facilities.
3) Rent of equipment, facilities, or land.
4) Indirect labor and contract supervisory wages plus payroll taxes, including payments to supplemental unemployment benefit plans.
5) Indirect materials and supplies.
6) Tools and equipment not otherwise capitalized.
7) Quality control and inspection.
8) Taxes otherwise allowable as a deduction (other than state, local, and foreign income taxes) that relate to labor, materials, supplies, equipment, land, or facilities. This does not include taxes treated as part of the cost of property.
9) Depreciation, amortization, and cost recovery allowance on equipment and facilities to the extent allowable as a deduction.
10) Depletion (whether or not in excess of cost).
11) Administrative costs, whether or not performed on a job site, but not including any costs of selling, or any return on capital.
12) Insurance, on your plant, machinery or equipment, or insurance on a particular activity.

For a more detailed list of indirect costs, see section 1.263A–1T(b)(2) of the Income Tax Regulations.

Costs provided by a related person. If materials, labor, or services are provided to you by a related person for a price less than the arm's-length charge for the items, special rules apply. See section 1.263A–1T(b)(2)(vi) of the Income Tax Regulations.

Interest. Interest must be capitalized for all items produced but not for property acquired for resale. Interest paid or incurred during the production period must be capitalized if the property produced is:

1) Real property,
2) Personal property with a class life of 20 years or more for purposes of determining depreciation,
3) Personal property with an estimated production period in excess of 2 years, or
4) Personal property with an estimated production period in excess of 1 year if the estimated cost of production is more than $1 million.

The production period begins on the date the production of the property begins and ends on the date the property is ready to be placed in service or is ready to be held for sale.

Costs not capitalized. Costs which are not required to be capitalized with respect to production or resale activities include amounts incurred for:

1) Marketing, selling, advertising, and distribution expenses.
2) Bidding expenses incurred in the solicitation of contracts not awarded to you.
3) General and administrative expenses (other than those determined to be indirect expenses, discussed earlier), and compensation paid to officers attributable to the performance of services not directly benefiting or not incurred by reason of a particular production activity.
4) Research and experimental expenses.
5) Casualty, theft, and other losses allowed by section 165 of the Internal Revenue Code.
6) Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle.
7) Income taxes.
8) Costs attributable to strikes.
9) Repair expenses that do not relate to the manufacture or production of property.

Intangible Assets

Intangible assets include goodwill, patents, copyrights, trademarks, trade names, and franchises. The basis of an intangible asset is usually its cost. If you acquire a number of assets for a lump-sum price, for example a going business, your basis of the individual assets is determined by allocating the total purchase price among the individual assets. If you bought a business, see *Allocating the Basis*, later, to figure the basis of the individual assets.

Goodwill. The basis of goodwill is usually its cost if you bought it. When you buy a going business and intend to continue the business, goodwill may be included in the price. See *Allocating the Basis*, later.

Agreement not to compete. Usually, the basis of an agreement not to compete (also called a covenant not to compete) is the amount you pay for it. If you buy a going business, however, a part of the price may be for an agreement not to compete.

Patents. The basis of a patent you buy is the amount you pay for it. If you get a patent for your invention, however, the basis is the cost of development, such as research and experimental expenditures, drawings, working models, and attorneys' and governmental fees. If you deduct the research and experimental expenditures as current business expenses, you cannot include them in the cost of the patent. The value of your time spent on an invention is not part of the basis.

Copyrights. When you buy a copyright, the basis is the amount you pay for it. However, if you are an author, your basis usually will be your cost of getting the copyright, plus copyright fees, attorneys' fees, clerical assistance, and the cost of plates that remain in your possession. This does not include the value of your time as the author.

Franchises, trademarks and trade names. If you buy a franchise, trademark, or trade name, the basis is its cost. See *Transfer of a Franchise, Trademark or Trade Name* in Publication 544, *Sales and Other Dispositions of Assets.*

Allocating the Basis

If you buy a group of assets for a lump sum, you should allocate the amount you pay to each of the assets you receive. You make this allocation to figure your basis for depreciation and gain or loss on a later disposition of any of these assets. See *Trade or business acquired,* later.

Group of assets acquired. If you buy a group of assets for a lump-sum price, you and the seller may agree to a specific allocation of the purchase price to each of the assets in the sales contract. If this allocation is based on the value of each asset, and you and the seller have adverse tax interests, the allocation generally will be accepted. However, see *Trade or business acquired,* next.

Trade or business acquired. If you acquire a group of assets that is a trade or business to which goodwill or going concern value could attach, you ***must*** use the following method to allocate the purchase price to the various assets acquired.

Allocate the purchase price to:

1) Cash and demand deposits and similar accounts, and then
2) Allocate the remaining purchase price to the following assets by allocating to each asset an amount of the remaining purchase price proportionate to, but not in excess of, its fair market value in the following order:
   a) Certificates of deposit, U.S. Government securities, readily marketable stocks or securities, and foreign currency,
   b) All other assets except goodwill and going concern value.

Any remainder of your purchase price, after you make these allocations, is your basis in goodwill and going concern value.

If you are a buyer or seller of a group of assets that is a trade or business, you must file Form 8594, *Asset Acquisition Statement,* with your income tax return for the year of sale.

Land and buildings. If you buy buildings and the land on which they stand for your business and you pay a lump-sum price for them, you must allocate the basis of the whole property among the land and the buildings so you can figure the depreciation allowable on the building. See Chapter 12.

When you allocate your cost between land and buildings or among the lots, the part of the cost that is used as the basis of each asset is the ratio of the fair market value of that asset to the fair market value of the whole property at the time you get it. If you are not certain of the fair market values of land and buildings, you may allocate the cost among them based on their assessed values for real estate tax purposes.

Demolition of building. The costs of demolition and other losses incurred in connection with the demolition of any building must be added to the basis of the land on which the demolished building was located, rather than claimed as a current deduction.

Subdivided lots. If you buy a tract of land and subdivide it into individual lots, you must allocate the basis to the individual lots based on the fair market value of each lot to the total price paid for the tract. This allocation is necessary because you must figure the gain or loss on the sale of each individual lot. As a result, you do not recover your entire cost in the tract until you have sold all of the lots.

If you sell lots before the development work is completed, see Revenue Procedure 75–25 (amplified in Revenue Procedure 78–25). This procedure explains how to get permission to add to the basis of each lot the estimated future cost of qualified development expenses.

Use of erroneous cost basis. If you made a mistake in figuring the cost basis of subdivided lots that you sold in previous years, you may not correct the mistake for years for which the statute of limitations has expired. You must figure the cost basis of any remaining lots by allocating the original cost basis of the entire tract among the original lots.

Example. You bought a tract of land to which you assigned a cost of $15,000. You subdivided the land into 15 building lots of equal size and equitably divided your cost basis so that each lot had a basis of $1,000. You treated the sale of each lot as a separate transaction and figured gain or loss separately on each sale.

Several years later it was determined that your original cost basis in the tract was $22,500 and not $15,000. You had sold 8 of the lots using $8,000 of basis in years for which the statute of limitations had expired. You now may take only $1,500 of basis into account for figuring gain or loss on the sale of each of the remaining 7 lots ($22,500 basis divided among all 15 lots). The basis of the 8 lots sold in tax years barred by the statute of limitations cannot be refigured.

Adjusted Basis

Before you can figure any gain or loss on a sale, exchange, or other disposition of property or figure allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

The basis of any property is increased by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property.

If you make additions or improvements to business property, you must keep separate accounts for these and depreciate the basis of each according to the depreciation rules in effect when the addition or improvement was placed in service. For more information, see Chapter 12.

Some items added to the basis of property are:

1) The cost of extending utility service lines to the property,
2) Legal fees, such as the cost of defending and perfecting title,
3) Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements,
4) Zoning costs, and
5) The capitalized value of a redeemable ground rent.

Assessments for local improvements. Assessments for items such as streets and sidewalks, which tend to increase the value of the property assessed, must be added to the basis of the property and not deducted as taxes. However, assessments for maintenance or repair or for meeting interest charges on the improvements are deductible as taxes.

Decreases to Basis

You must decrease the basis of your property by any items that represent a return of capital. Some of these include:

1) The section 179 deduction,
2) Nontaxable dividends,
3) Recognized losses on involuntary exchanges, and
4) Deductions previously allowed (or allowable) for amortization, depreciation, obsolescence, and depletion.

You also decrease the basis if you receive a rebate from the manufacturer or seller. This actually is a reduction of your purchase price.

Section 179 deduction. If you elect to take the section 179 deduction for any part of the cost of property, you must decrease the basis of the property by the amount of the section 179 deduction. For more information, see Chapter 12.

Casualties and thefts. If you have a casualty or theft loss, you must decrease the basis of your property by the amount of any insurance or other reimbursement you receive and by any deductible loss not covered by insurance. However, increase your basis for amounts you spend after a casualty to restore the damaged property. For more information, see Chapter 25.

Easements. The amount you receive for granting an easement is usually considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, your basis is reduced to zero and the excess is a recognized gain. See *Easements* in Chapter 21.

Diesel-powered vehicle. If you received an income tax refund or credit for buying a diesel-powered highway vehicle, reduce your basis in the vehicle by the amount of the credit or refund allowable. For more information about this credit or refund, see Publication 378, *Fuel Tax Credits and Refunds.*

Depreciation. You must decrease the basis of your property by the amount of depreciation you could have deducted on your tax returns under the method of depreciation you selected. If you deducted more depreciation than you should have, decrease your basis by the amount you should have deducted plus that part of the excess that resulted in a decrease in your tax liability for any year. If you took less depreciation than you could have, decrease your basis by the amount you could have deducted. If you did not take a depreciation deduction, figure the amount of depreciation you could have deducted as explained in Chapter 12.

In decreasing your basis for depreciation, be careful to take into account not only the amount deducted on your tax returns as depreciation expense, but any depreciation you were required to capitalize under the uniform capitalization rules.

Adjusted Basis Example

In 1985 you paid $80,000 for real property to be used as a factory. You also paid commissions of $2,000 and title search and legal fees of $600. You allocated the total cost of $82,600 between the land and the building—$10,325 for the land and $72,275 for the building. Immediately, you spent $20,000 in remodeling the building before you placed it in service. You were allowed depreciation of $28,200 for the years 1985 through 1989. In 1988 you had a casualty loss of $5,000 on the building from a fire that was not covered by insurance, and this loss was claimed as a deduction. You spent $5,500 to repair the fire damages. The adjusted basis of the building on January 1, 1990, is figured as follows:

		Building
Original cost of building, including fees and commissions		$72,275
Adjustments to basis:		
Add: Improvements		20,000
Repair of fire damage		5,500
		$97,775
Subtract:		
Depreciation	$28,200	
Casualty loss	5,000	33,200
Adjusted basis on January 1, 1990		$64,575

The basis of the land, $10,325, remains unchanged. It is not affected by any of the above adjustments, which affect only the basis of the building.

Other Basis

There are many times when you cannot use cost as a basis. In these cases, the fair market value of the property, or the adjusted basis of certain property may be important.

Fair market value (FMV). FMV is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property, on or about the same date, may be helpful in figuring the FMV of the property.

Property for services. If you receive property for services, you must include the property's FMV in income. The amount you include in income becomes your basis.

Restricted property. If you receive property for services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested. Property becomes substantially vested when you can transfer it or it is not subject to a substantial risk of forfeiture. For more information on restricted property, see the discussion on *Restricted Property Received for Services,* in Publication 525, *Taxable and Nontaxable Income.*

Taxable exchanges. A taxable exchange is an exchange in which the gain is taxable, or the loss is deductible. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

Casualties, Thefts, and Condemnations

If you acquire property as a result of a casualty, theft, or condemnation, the basis of the replacement property may be figured using the basis of the property exchanged. See Chapter 25.

Similar or related property. If you receive property that is similar or related in service or use to the property exchanged, the basis of the new property is the same as the basis of the old property on the date of the exchange with the following adjustments:

1) Decreased by—
    a) Any loss recognized on the exchange, and
    b) Any money received that was not spent on similar property.
2) Increased by—
    a) Any gain recognized on the exchange, and
    b) Any cost of acquiring replacement property.

Not similar or related property. If you receive money or other property that is not similar or related in service or use to the old property, and you buy new property that is similar or related in service or use to the old property, the basis of the new property is the cost of the new property decreased by the amount of gain that is not recognized on the exchange.

Example. Your property was condemned by the state. The property had an adjusted basis of $26,000, and the state paid you $31,000 for it. You realized a gain of $5,000 ($31,000 − $26,000). You bought new property that is similar in use to the old property for $29,000, and you recognize a gain of $2,000 ($31,000 − $29,000), the unspent part of the payment from the state. The basis of the new property is figured as follows:

Cost of new property	$29,000
Minus: Gain not recognized	3,000
Basis of the new property	$26,000

Allocating the basis. You must allocate the basis among the parts of the new property you acquire as a result of an involuntary exchange. This allocation usually is based on the ratios of the FMV of each part of the new property to the total FMV of the whole new property. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

If, in the previous example, the state had condemned unimproved real property, and the new property you bought was improved real property with both land and buildings, you would allocate the basis of the new property, $26,000, between land and buildings based on their FMV.

See Chapter 25 for more information on the involuntary exchange rules.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which any gain is not taxed and any loss cannot be deducted. If you receive property in a nontaxable exchange, its basis is usually the same as the basis of the property you exchanged.

The exchange must meet the following conditions to be nontaxable:

1) The property must be business or investment property. You must hold the property you exchange and the property you receive for business or investment purposes. You may not use either property, such as your home or family car, for personal purposes.
2) The property must be "like-kind" property. The exchange of real estate for real estate, or personal property for similar personal property, is a trade of like property. The exchange of an apartment house for a store building, or a panel truck for a pickup truck, is a like-kind exchange. The exchange of a piece of machinery for a store building is not a like-kind trade. The exchange of real property located in the United States for real property located outside the United States is not a like-kind exchange.
3) The property must be tangible property. These rules and benefits generally do not apply to exchanges of stocks, bonds, notes, or certain other intangible property.
4) The property must not be property held for sale. The property you exchange and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for use in your business or for investment.
5) The property you receive must meet identification requirements. The property to be received in the exchange must be identified on or before the day that is 45 days after the date of transfer of the property you exchange.
6) The trade must meet the completed transaction requirement. The property to be received in the exchange must be received before the earlier of:
    a) The 181st day after the date of transfer of the property you exchange, or
    b) The due date, including extensions, for your tax return for the tax year the property you exchange is transferred.

See Chapter 21 for a more detailed discussion of nontaxable exchanges.

Example. If you exchange real estate held for investment that has an adjusted basis of $50,000 and a FMV of $80,000 for other real estate held for investment having a FMV of $80,000, the basis of the new property is $50,000, the same basis as the old property.

Property plus cash. If you trade property in a nontaxable exchange and pay an additional amount, the basis of the property you receive is the basis of the property you exchanged increased by the additional amount you paid.

Example. If you trade in a truck that has an adjusted basis of $3,000 for another truck that has a FMV of $7,500, and also pay $4,000 cash for the new truck, the basis of the new truck is $7,000 (the $3,000 basis of the old truck plus the $4,000 cash paid).

Special rules for related persons. Generally, when related persons exchange like-kind property, the nontaxable exchange rules apply. However, for exchanges made directly or indirectly between related persons after July 10, 1989, the exchange is disqualified from this treatment if either party disposes of the like-kind property within 2 years after the exchange. Each related person must report any gain or loss not recognized on the original exchange on the tax return filed for the year in which the later disposition occurred. If this special rule applies, your basis in the property received in the original exchange will be its fair market value.

These rules generally do not apply to dispositions due to:

1) The death of either related person,
2) Involuntary conversions, or
3) Exchanges whose main purpose is not the avoidance of federal income tax.

Related persons. Generally, related persons are ancestors, lineal descendants, brothers and sisters (whole and half blood), and a spouse.

For other related persons, such as two or more corporations, an individual and a corporation, a grantor and fiduciary, etc., see the rules relating to losses under *Sales and Exchanges Between Related Parties* in Chapter 2 of Publication 544, *Sales and Other Dispositions of Assets.*

Exchange of businesses. The exchange of assets of one business for the assets of another business is an exchange of multiple assets and cannot be treated as a disposition of a single property. The various assets that comprise each business must be checked to determine which are like-kind exchanges.

The assets treated as transferred in exchange for like-kind property are excluded from the allocation rules. See the discussion under *Trade or Business Acquired* under *Allocating the Basis,* in Publication 551, *Basis of Assets.* However, property that is not like-kind property is subject to the allocation rules.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the same as the basis of the old property with the following adjustments:

1) Decreased by—
    a) Any money you received, and
    b) Any loss recognized on the exchange.
2) Increased by—
    a) Any additional costs incurred, and
    b) Any gain recognized on the exchange.

The assumption of your liabilities (including a nonrecourse obligation) by the other party to the transaction is treated as money transferred to you in the exchange.

The basis must be allocated among the properties, other than money, that you received in the exchange. In making this allocation, the basis of the unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Example 1. If you exchange a truck that has an adjusted basis of $6,000 for a new, smaller truck that has a FMV of $5,200, and in addition you receive $1,000 in cash, you have a recognized gain of $200 ($6,200 − $6,000). Your basis in the new truck is figured as follows:

Adjusted basis of old truck	$6,000
Minus: Cash you received	1,000
	$5,000
Plus: Gain recognized	200
Basis of new truck	$5,200

Example 2. You had an adjusted basis of $15,000 in real estate you held for investment. You exchange it for other real estate to be held for investment with a fair market value of $12,500, a truck with a FMV of $3,000, and $1,000 cash. You have a gain of $1,500 ($16,500 − $15,000) recognized on the exchange. The basis of the properties you received is figured as follows:

Adjusted basis of real estate transferred	$15,000
Minus: Cash received	1,000
	$14,000
Plus: Gain recognized	1,500
Total basis of properties received	$15,500

You must allocate the total basis of $15,500 between the truck and the real estate. The basis of the truck is its FMV, $3,000, and the basis of the real estate is the remainder, $12,500.

Trade-in or sale and purchase. You cannot increase the basis of property for depreciation by selling your old property outright to a dealer and then buying the new property from the same dealer, if the sale and purchase are actually a single transaction. If the sale of your old property and your purchase of the new property are dependent on each other, you are considered to have traded in your old property. The transaction is treated as an exchange no matter how it is carried out. You cannot avoid this trade-in rule by using a subsidiary in the transaction.

Exchange — loss not recognized. If you have an exchange that results in an unrecognized loss, the basis of the new property is the basis of the old property decreased by any money received. Allocate this basis among the properties, other than money, received in the exchange. In making this allocation, the basis of unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Example. You exchanged a fishing boat used in your business that has an adjusted basis of $18,000 for a smaller fishing boat to be used in your business that has a FMV of $14,000, a truck for personal use that has a FMV of $2,500, and $500 cash. The loss of $1,000 ($17,000 − $18,000) is not recognized. Your basis in the properties you receive is:

Adjusted basis of your old boat	$18,000
Minus: Cash you received	500
Total basis of properties received	$17,500

Of the total basis of $17,500, $2,500 is for the truck you received and the remaining $15,000 is the basis of your new boat.

Partial Business Use of Property

If you have property used partly for business and partly for personal use, and you exchanged in a nontaxable exchange for property to be used wholly or partly in your business, the basis of the property you receive is figured as if you exchanged two properties. The first is an exchange of like-kind property. The second is personal-use property on which gain is recognized and loss is not recognized.

First figure your adjusted basis in the property you transfer as if you transferred two separate properties. Figure the adjusted basis of each portion of the property by taking into account any adjustments to basis. Deduct the depreciation you took or should have taken from the adjusted basis of the business portion. Then figure the amount realized for your property and properly allocate it to the business and nonbusiness portions of the property you transferred.

In this case, you exchanged property permitted to be exchanged tax free. You also exchanged other property not permitted to be transferred without recognizing gain or loss. Gain from the transaction is recognized on your personal-use property. The basis of the property acquired is the total basis of the properties transferred, adjusted to the date of the exchange, increased by the amount of gain, and decreased by the amount of loss recognized on the other property. You are deemed to have received in exchange for your other property an amount equal to its fair market value on the date of the exchange.

Listed property. Special rules apply to listed property not used more than 50% in your business. Listed property includes any automobile, other property used for transportation, property used for entertainment such as photographic and video recording equipment, cellular telephone or similar equipment, and computers and related peripheral equipment not used exclusively at a regular business location.

For listed property used in your trade or business, the adjusted basis of the property is figured as if all use of the property was in your trade or business.

This requires that you reduce the adjusted basis of listed property by depreciation figured as if the property was used 100% for business even if a lesser amount was allowable because the property was not used 100% in your trade or business. The application of these rules to a car is explained and illustrated in Publication 917, *Business Use of a Car,* under *Trade-in.*

Property changed to business or rental use. When you hold property for personal use and change it to business use or use it to produce rent, you must figure the basis for depreciation.

Basis for depreciation. The basis for depreciation equals the lesser of:

1) The FMV of the property on the date of the change, or
2) Your adjusted basis on the date of the change—that is, your original cost or other basis of the property, plus the cost of permanent improvements or additions since you acquired it, and minus deductions for any casualty losses claimed on earlier years' income tax returns and other decreases to basis.

Example. Several years ago you built your home for $60,000 on a lot that cost you $10,000. Before changing the property to rental use last year, you added $20,000 of permanent improvements to the house and claimed a $2,000 deduction for a casualty loss to the house. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house at the time of the change in use is $78,000 ($60,000 + $20,000 − $2,000). On the date of change, your property has a FMV of $80,000, of which $15,000 is for the land and $65,000 for the house. The basis for depreciation on the house is $65,000, the FMV at the date of the change in use, because it is less than your adjusted basis ($78,000).

Sale of property. If you later sell or dispose of the property, the basis of the property to use will depend on whether you are figuring gain or loss.

Gain. The basis for gain is your adjusted basis when you sell the property—that is, your original cost or other basis, plus the cost of any permanent improvements or additions and minus depreciation allowed or allowable, deductions for casualty losses claimed on prior years' returns, and other decreases to basis, such as amounts received for easements or rights-of-way.

Loss. The basis for loss is figured using the smaller of your adjusted basis or the FMV at the time of the change in use. Adjust this amount for improvements and additions, depreciation, casualty loss deductions, etc., for the period since the property was changed to business or rental use.

Part III
Figuring Gross Profit

This Part discusses the items that go into figuring the gross profit of your business—gross receipts and the cost of goods sold. The method for figuring gross profit is essentially the same whether your business is a sole proprietorship, a partnership, or a corporation.

7. Business Income

You must report on your tax return any income you receive from your trade or business or any other source unless it is excluded by law. The income may be in the form of cash, property, or services. Some types of income are:

1) Interest, dividends, rents, royalties;
2) Payment for services, including fees, commissions, fringe benefits, and similar items;
3) Gains from dealings in property (see Chapter 21);
4) Income from the discharge of indebtedness; and
5) Distributive shares of partnership gross income (see Chapter 28).

This chapter is mainly concerned with income from a trade or business.

Business income is income that you receive when you sell your product or services. Interest is business income to a lending company. Fees are business income to a professional person. Rents are business income to a person in the real estate business. Dividends generally are business income to a dealer in securities. All income received by a corporation is business income regardless of source.

Example. You work full-time as a mechanical engineer for an aircraft manufacturer. During your nonworking hours you are an artist. The income you receive from the sale of your paintings is business income.

Assignment of income. All income that you earn is taxable to you. You cannot avoid the tax by having the income paid to a third party.

Example. You rent out your property and the rental agreement directs the tenant to pay the rent to your son. The amount paid to your son is gross income to you.

Property or services (bartering). An exchange of property or services for your property or services is sometimes called ***bartering.*** Income received in the form of property or services must be included in income at its fair market value on the date received. If you receive the goods or services of another in return for your goods or services and you both have definitely agreed ahead of time as to the value of the goods or services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Example 1. You perform legal services for a client, a small corporation. In payment for your services, you receive shares of stock in the corporation. You must include the fair market value of the shares in income.

Example 2. Both you and a house painter are members of a barter club, an organization that each year gives its members a directory of members and the services each member provides. Members get in touch with other members directly and bargain for the value of the services to be performed.

In return for accounting services you provided for the house painter's business, the house painter painted your home. The fair market value of the services you received from the house painter must be included in your income, and the fair market value of your accounting services must be included in the house painter's income.

Example 3. You are a member of a barter club that uses credit units to credit or debit members' accounts for goods or services provided or received. As soon as units are credited to a member's account, the member may use them to buy goods or services or may sell or transfer the units to other members.

The value of credit units received must be included in your gross income for the tax year in which the units are credited to your account.

The dollar value of units received for services by an employee of the club, who may use the units in the same manner as other members, must be included in the employee's gross income for the tax year in which received and is wages for purposes of social security taxes (FICA), federal unemployment taxes (FUTA), and income tax withholding. See Chapter 33.

Example 4. You are a cash method taxpayer. You join a barter club and agree to provide specific services to any member for a specified number of hours. Each member has access to a directory that lists the members of the club and the services available.

Members contact each other directly and request services to be performed. You are not required to provide services unless requested by another member, but you may use as many of the offered services as you wish without paying a fee.

You must include the fair market value of any services you receive from club members in your income when you receive them even if you have not provided any services to club members.

When included in income. If you receive income in the form of property or services, you may have to include the value of the property or services in your income even before you get physical possession of the property or make use of the services. See *Constructive receipt,* later in this chapter.

Rents. If you receive property or services as a payment of rent, you must include the fair market value of the property or services in your income.

Example. You own an apartment building, and you received a work of art created by an artist in return for the artist's rent-free use of an apartment for six months. The fair market value of the art work is included in your income, and the fair rental value of the apartment is included in the artist's gross income.

Property as dividend. Property received as a dividend is discussed in Chapter 29.

Information returns. If you are involved in a bartering transaction you may be required to file information returns. See Chapter 36, *Information Returns,* for more details.

Kinds of Income

Following is a list of various types of income you may receive in your business.

Rental income. The amount you get from the rental of any property is included in your gross income. In the case of rental property, gross income means gross receipts from rents.

Prepaid rent. Advance payments received under a lease that does not put any restriction on their use or enjoyment are income in the year they are received. This is true no matter what accounting method or period you use.

Lease bonus. A bonus that you receive from a tenant for granting a lease is an addition to the rent and must be included in your rental income in the year that it is received.

Lease cancellation payments. Payments that you receive from your tenant for canceling a lease must be reported in gross income in the year received.

Payments to third parties. If your tenant makes payments to someone else under an agreement to pay debts or obligations of yours, the payments are included in your rental income when the tenant makes the payments. A common example of this kind of income is a tenant's payment of the landlord's property taxes on leased real property.

Settlement payments. Payments received by the lessor in settlement of a tenant's obligation to restore the leased property to its original condition are income in the amount that the payments exceed the adjusted basis of the leasehold improvements destroyed, removed, or disconnected by the tenant. See *Section 1231 Property* in Chapter 22.

Interest received on loans. This interest is business income if you are in the business of lending money. In any business, interest received on notes receivable that you have accepted in the ordinary course of business is business income.

Discounted loans. If you are in the loan business, any payment that you receive on a discounted loan usually includes both principal and interest. If you are a cash basis taxpayer, part of the discount is interest income to you when you receive each payment. If you are an accrual method lender, the amount of the discount is includible in your income as it accrues over the term of the loan, or it is includible as you receive the payments if you receive the payments before they accrue.

Uncollectible loans. If a loan payable to you becomes uncollectible during the tax year, and you are on the accrual method, you must include in gross income interest accrued up to the time the loan became uncollectible. If the accrued interest later becomes uncollectible, you may be able to take a bad debt deduction. See Chapter 14.

Unstated interest. If little or no interest is charged on an installment sale, unstated interest is considered to be included in the payments received. See Chapter 24.

Dividends. Generally, dividends are business income to dealers in securities. They also are business income to partnerships and corporations that have invested their funds in stocks. To most people engaged in business, however, dividends are ***nonbusiness income.*** If an individual holds stock as a personal investment separately from the individual's business activity, the dividends from the stock are nonbusiness income.

Bond premium. If a corporation issues bonds and gets more than the face value of the bonds in return, the amount received that is greater than the face value is called bond premium. Bond premium is included in the corporation's income, but not all of it is included in the year the bonds are issued. Part of the premium is included in income in each tax year during the term of the bonds.

To figure how much to include for each tax year, divide the amount of time the bonds are outstanding during the year by the term of the bonds from the date of issue to the date of maturity. Then multiply this answer by the total bond premium. Other interest-bearing obligations issued by corporations, such as debentures, notes, and certificates, are treated the same way.

Original issue discount. If a bond is issued for a price that is lower than what the issuer will pay the bondholder when the bond matures, the difference between these two amounts is called original issue discount. Original issue discount is just the opposite of bond premium, explained above. You include bond premium in your income if you are the issuer of the bond, and you include original issue discount in your income if you are the purchaser of the bond.

Original issue discount must be included in your gross income as ordinary income even though the bond is a capital asset in your hands. However, if the original issue discount is less than one-fourth of 1% of the stated redemption price at maturity times the number of full years from original issue to maturity, the original issue discount is considered to be zero.

Original issue discount on notes that are issued by a municipality is considered tax-exempt interest if the notes are not industrial development bonds or arbitrage bonds. However, any gain on the sale or redemption of a municipal bond is not tax-exempt interest. See Publication 550, *Investment Income and Expenses.*

For corporate bonds issued before May 28, 1969, or for government bonds issued before July 2, 1982, you are not required to include the original issue discount in income until the year the bond (or other evidence of indebtedness) is sold, exchanged, or redeemed. This also applies to corporate bonds issued under a written contract that was binding on May 27, 1969, and continues to be binding until the date of issue.

If you are the holder of a corporate bond or other evidence of indebtedness issued after May 27, 1969, you must also include original issue discount in your income. But it is not all included in one tax year. Instead, part of it is included in income for each tax year during which you own the bond. The rules for figuring how much discount to include in your income for a tax year are different for obligations issued after July 1, 1982.

For information on how much original issue discount to include in your income for a tax year, see Publication 1212, *List of Original Issue Discount Obligations.*

Restricted property. If you receive restricted stock or other property for services performed, the fair market value of the property, in excess of your cost is included in your income when the restriction is lifted. However, you may elect to be taxed in the year you receive the property. For more information on restricted property as income, see Publication 525, *Taxable and Nontaxable Income.*

Capital gains. Gains you have from the sale or exchange of your capital assets are included in your gross income. Under certain conditions some business assets may be treated as capital assets when they are sold or exchanged. See Chapter 22.

Franchises, trademarks, trade names. Amounts that you receive or accrue during your tax year that are based on the productivity, use, or disposition of a franchise, trademark, or trade name are generally includable in gross income as ***ordinary income.*** See Chapter 22.

Promissory notes. Negotiable promissory notes and other evidences of indebtedness, given to you by a responsible and solvent maker are reported in your gross income at their fair market value when received, if they are received as a part of your sales price and you use the cash method of accounting.

Discounting notes receivable. The discounting of notes receivable is a common practice in some businesses. Many dealers receive the notes of customers as payment for articles sold. These notes are payable over a fixed period of time. The dealer then sells the notes to a finance company, usually for an amount lower than the face value of the notes.

The dealer and the finance company often agree that a part of the price will be held by the finance company in a ***dealer's reserve*** or similar account until collections are made or the reserve reaches a specified total. Then the finance company pays or credits the amount in the reserve to the dealer. Amounts held in the reserve are considered income to the dealer.

Under an accrual method of accounting, the full amount of the discount price, not reduced by the reserve held by the finance company, is included in income when the notes are sold. This practice of discounting notes receivable sometimes is used by automobile dealers.

Losses on worthless notes. Losses on worthless notes that the finance company may charge against the reserve have no bearing on the fact that taxable income has been received by the dealer.

Canceled debt. A canceled debt is generally income to the debtor. If you settled a debt by delivering to your creditor property that cost you less than the amount owed, the difference is income to you—unless you are insolvent. If you are ***insolvent*** before the cancellation but solvent after the cancellation, you realize income to the extent the transaction makes you solvent. This is the amount by which the fair market value of your assets is more than your liabilities after the cancellation. If you are insolvent before the cancellation, and remain insolvent or have no excess of assets over liabilities after the cancellation, you realize no income.

If your canceled debt is qualified farm indebtedness, you are treated as being insolvent to the extent of this canceled debt. See *Cancellation of Indebtedness* in Chapter 4 of Publication 225, *Farmer's Tax Guide.*

Stockholder cancels debt. If you, as a stockholder, gratuitously cancel a debt owed to you by the corporation, the transaction is generally a contribution to the capital of the corporation in the amount of the canceled principal portion of the debt, so no income is realized by the corporation. However, a solvent, accrual method corporation may be required to report as income any unpaid interest it previously deducted on its debt to you. In the year the debt is forgiven, the corporation would include in gross income the unpaid interest it had deducted, but only up to the amount of the deductions that had lowered its tax in earlier tax years.

Damages. The compensation you received during the tax year as a result of a patent infringement, certain ***breaches of contract*** or fiduciary duty, or antitrust injury, is income that you must include in gross income. However, you may be entitled to a deduction against this income if it compensates you for actual economic injury. Your deduction is the smaller of:

1) The amount you received or accrued for damages in the tax year reduced by the amount you paid or incurred in the tax year to recover that amount, or
2) The amount of your losses you had from the injury that you have not yet deducted.

Punitive damages. Punitive damages also are income that you must include.

Kickbacks. Any kickbacks that you receive are included in your income. However, do not include them in your income if you properly treat them as a reduction of a related expense item, of cost of goods sold, or of a capital expenditure.

Recovery of items previously deducted. If you recover a bad debt, prior tax, or any item deducted in a previous year, you must include the recovery in your income. However, if all or part of the deduction in earlier years did not reduce your tax, you may not have to include all of the recovered amount in your income. Exclude an amount equal to any part that did not reduce your tax. If you exclude part of the recovery from your income, you must include with your return a computation showing how you figured the exclusion.

Example 1. In 1990, the Maple Corporation had gross income of $8,000, a bad debt deduction of $300, and other allowable deductions of $7,700. If, in a later year, the Maple Corporation recovers all or part of the $300 bad debt, it must include the recovery in income in the year of recovery.

Example 2. Joe Smith, a sole proprietor, had the same income and deductions as the Maple Corporation in the preceding example. He also had personal exemptions of $4,100. He would not pay income tax even if he did not deduct the bad debt. Thus, he will not have to report as income any part of the $300 that he may recover in any future year.

Depreciation, depletion, or amortization. Amounts deducted for these items in a prior year are not amounts for which you can claim no tax benefit was received. You must use any net operating loss carryovers and carrybacks and capital loss carryovers (or carrybacks for a corporation) to figure whether the previous deduction or credit actually reduced your tax for any prior year.

Recapture of depreciation. If your business use of an asset, that is listed property, falls to 50% or less in a tax year after the tax year you placed the asset in service, you may have to include in your income some of the depreciation you deducted in prior years. See *Partial Business Use of Listed Property* in Publication 534, *Depreciation*. This depreciation is business income that you must include in income because of your decreased business use of the asset.

If you take a section 179 deduction for an asset and before the end of the second tax year after the year you took the deduction the asset is not used predominantly in business, you must recapture the section 179 deduction. You do this by including in your income part of the deduction you took. This amount is also business income. See *Recapture of Section 179 Deductions* in Publication 534.

Items That Are Not Income

In some cases the receipt of property or money is not income.

Issuance of stock. Issuing stock does not produce income for a corporation regardless of the amount for which the stock was issued. This also applies to the sale of ***treasury stock***.

Contribution to capital. A contribution to capital by an owner or stockholder of a business is not income to the business. In the case of a corporation, contributions to capital by nonstockholders are not always included in gross income. Contributions to capital or other payments to a corporation by persons who are ***not*** direct beneficiaries of a service rendered or to be rendered by the corporation are not included in the corporation's gross income. However, the basis of property contributed or property purchased with money contributed by nonshareholders must be adjusted.

For example, a contribution made to a corporation by a chamber of commerce or civic organization to induce the corporation to locate in its area is not includible in the gross income of the corporation.

Contributions to capital or other payments to a corporation by persons who ***are*** direct beneficiaries of a service rendered or to be rendered by the corporation are included in the corporation's gross income.

For example, to be entitled to receive service, subscribers to a television transmission service must contribute a specified sum toward the cost of constructing the facility for supplying the television signal. They must also pay a monthly maintenance charge. The initial contribution is neither a gift nor a contribution to capital, but is part of the payments for services.

Loans. Money borrowed through a bona fide loan is not income.

Appreciation. Increases in value of your property are not income until you realize the increases through a sale or other taxable disposition.

Leasehold improvements. If a tenant erects buildings or makes improvements to your property, the increase in the value of the property that is due to the improvements is not income to you. However, if the facts indicate that the improvements are a payment of rent to you, then the increase in value would be income.

Exchange of property for like property. If you exchange your business property or property you hold for investment solely for property of a like kind to be used in your business or to be held for investment, no gain or loss is recognized. A common type of nontaxable exchange is the trade-in of a business automobile for another business automobile. See Chapter 21.

Consignments. Consignments of merchandise to others to sell for you are not sales. The title of merchandise remains with you, the consignor, even after the consignee possesses the merchandise. Thus, if you ship goods on consignment, you have no profit or loss until the merchandise has been sold by the consignee. Merchandise that you have shipped out on consignment is included in your inventory until it is sold.

Merchandise that you receive on consignment is never included in your inventory. Your profit or commission on merchandise consigned to you is included in your income when you sell the merchandise or when you receive your profit or commission, depending upon the method of accounting you use.

Accounting for Your Income

Accounting for your income for income tax purposes differs at times from accounting for financial purposes. This section discusses some of the more common differences that may affect business transactions.

The income from your business is figured on the basis of a tax year (see Chapter 3) and according to your regular method of accounting (see Chapter 4). If the sale of a product is an income-producing factor in your business, the use of inventories usually is required to clearly show your income. Dealers in real estate are prohibited from using inventories. See Chapter 8 for more information on inventories.

Cash discounts. These are amounts that the seller permits you to deduct from the invoice price for prompt payment. For income tax purposes you may use either of two methods to account for cash discounts. You may:

1) Deduct the cash discount from purchases (see Chapter 8); or
2) Credit the cash discount to a discount income account.

You must use the method you select every year for all your purchase discounts.

If the second method is used, the credit balance in the account at the end of your tax year is business income. Under this method, the cost of goods sold is not reduced by the cash discounts you received. When valuing your closing inventory, you may not reduce the invoice price of merchandise on hand at the close of the tax year by the average or estimated discounts received on the merchandise.

Trade discounts. These are reductions from list or catalog prices and usually are not written into the invoice or charged to the customer. These discounts are not entered on your books of account. Only the net amount is included for purchases. See *Trade discounts* in Chapter 8.

Constructive receipt. Income is constructively received when it is credited to your account or set apart in a way that makes it available to you. You do not need to have physical possession of it. If you use the cash method of accounting, the income must be reported in the year it is constructively received. See Chapter 4.

Example. Frances Jones, a service contractor, was entitled to receive a $10,000 payment on a contract in December 1990. She was told in December that her payment was available. At her request, she was not paid until January 1991. However, she must include this payment in her 1990 income because it was constructively received in 1990.

Checks. A valid check received before the close of the tax year is constructive receipt of income in that year, even though you do not cash or deposit the check until the following year.

Example. Dr. Red received a check for $500 on December 31, 1990, from a patient. This check was not deposited in her business account until January 2, 1991. This fee must be included in her income for 1990.

Agents. An agent is someone who engages in business transactions for you. Income is constructively received by you in the year your agent receives it.

Partnerships. If you are a member of a partnership, you are required to include in income your share of the partnership profits whether or not they are distributed to you. For each tax year, include your share of the profits from the partnership's tax year that ends during your tax year or that ends on the same day that your tax year ends.

Debts paid by another person or canceled. If your debts are paid by another person or are canceled by your creditors, you may have to report part or all of this debt relief as income. If you get income in this way, the income is constructively received by you when the debt is canceled or paid. See *Canceled debt*, earlier.

Payment placed in escrow. If part or all of the purchase price is placed in escrow by the buyer, you should not include any part of it in gross sales until it is actually or constructively received. However, upon completion of the terms of the contract and the escrow agreement, you will have taxable income, even if you do not accept the money until the next year.

Insurance proceeds. These are discussed in Chapters 17 and 25.

Sales returns and allowances. Credits you allow customers for returned merchandise and any other allowances you make on sales are deductions from gross sales in figuring net sales.

Prepaid Income

Prepaid income is generally included in your gross income in the year that it is received. But, the amount received is not income unless it is subject to your free and unrestricted use. Prepaid income must be treated this way whether you use the cash or accrual method of accounting. However, if you use the accrual method and meet the conditions explained in *Advance Income for Services*, below, you may be able to postpone including these amounts in income until the year you earn them.

If you must repay any part, or all, of the prepaid income in a later year, you may ordinarily deduct the repayment in the year you make it. See Chapter 19.

Advance Income for Services

If you use the accrual method of accounting and, under an agreement, you receive advance payments for services to be performed by the end of the next tax year, you may postpone including the advance payments in income until you earn them. However, you may not postpone including them beyond the year after the year you receive them.

Service agreements. You may postpone reporting in income the advance payments you receive under service agreements (including agreements providing for incidental replacement of parts or materials) that are for property that you offer to sell, lease, build, or install without service agreements in the normal course of business.

Guarantees and warranties. You may not postpone reporting in income amounts that you receive under guarantee or warranty contracts.

Prepaid rent or prepaid interest. You cannot postpone reporting income from prepaid rent or for prepaid interest. Prepaid rent does not include payments for use of rooms or other space when significant services are also provided for the occupant. You provide significant services when you supply space in hotels, boarding houses, tourist homes, motor courts, motels or apartment houses that furnish hotel services.

General rules. Usually you may not postpone including advance payments for services if, under the agreement:

1) You are to perform any part of the services after the end of the tax year immediately following the year you receive the advance payments, or
2) You are to perform any part of the services at any unspecified future date which may be after the end of the tax year immediately following the year you receive the advance payment.

Any advance payment that you include in gross receipts in the tax year you receive the payment may not be less than the amount of the payment you include as gross receipts in gross income in your books and records and all your reports (including consolidated financial statements) to shareholders, partners, and other proprietors or beneficiaries, and in reports you prepare for credit purposes.

If you want to defer advance payments received for services as described above and you are not now using this method to report your income, you must first have consent from the IRS. See Chapter 4 for information on how to apply for a change in your accounting method.

All of the following examples use the calendar year as the tax year and the accrual method of accounting.

Example 1. You manufacture, sell, and service television sets. In 1990 you received payment for a one-year contingent service contract on a television set you sold. You may postpone including these payments in income, if you offer the television sets for sale without the contingent service contracts in the normal course of your business.

Example 2. You are in the television repair business. In 1990 you received payments for one-year contracts under which you agree to repair or replace certain parts that fail to function properly in television sets that were sold by an unrelated party. You may include the payments in gross income as you earn them over the period of the contract.

Example 3. You own a dance studio. On November 2, 1990, you received payment for a one-year contract beginning on that date and providing for 48 one-hour lessons. You gave eight lessons in 1990. Under this method of including advance payments, you must include one-sixth of the payment in income for 1990, and five-sixths of the payment in 1991, even if you cannot give all the lessons by the end of 1991.

Advance Income from Sales

If you use the accrual method of accounting, any advance payments you receive for future sales or other dispositions of goods are included in your income under special rules. Under these rules, advance payments include those you receive under an agreement for future sales of goods you hold primarily for sale to your customers in the ordinary course of your trade or business. They also include payments received under agreements for building, installing, or manufacturing items if you do not complete the agreement in the tax year.

If the advance payments are for contracts involving both sale and service of goods, it may be necessary to treat them as two agreements. An agreement also means a gift certificate that can be redeemed for goods. Amounts that are due and payable are treated as received.

Inclusion in income. You may choose when to report the advance payments in income. You may include them in income in the tax year in which you receive them. Under an ***alternative method,*** you may include them in income in the ***earlier*** of the:

1) Tax year in which you include the advance payments in gross receipts under the method of accounting that you use for tax purposes; or
2) Tax year in which you include any part of the advance payments in any of your financial reports under the method of accounting used for those reports.

Your financial reports include consolidated financial statements, your reports to shareholders, partners, beneficiaries, and other proprietors, and reports you prepare for credit purposes.

Example 1. You are a retailer who uses an accrual method of accounting under which you account for your sales of goods when you ship the goods. You use this method for both tax and reporting purposes. Therefore, you must include advance payments you receive in gross receipts for tax purposes either in the tax year you receive the payments or in the tax year you ship the goods.

Example 2. You are a calendar year taxpayer who makes household furniture. You use the accrual method of accounting. Under your method of accounting, you accrue income for your financial reports when you ship the furniture. For tax purposes, you do not accrue income until the furniture has been delivered and accepted.

In 1989, you received an advance payment of $8,000 from a customer for an order of furniture to be made for a total price of $20,000. You shipped the furniture to your customer in December 1989, but it was not delivered and accepted until January 1990.

You must include the entire $8,000 advance payment in your gross income for tax purposes in 1989. You include the remaining $12,000 of the contract price in your gross income, for tax purposes, in 1990.

Exception for inventory goods. If you receive advance payments under an agreement for the sale of goods that are included in your inventory or under an agreement, such as a gift certificate, that can be satisfied with goods or a type of goods that cannot be identified in the year of sale, you may be able to postpone including the advance payments in income in the year of receipt. However, you may postpone including these payments until no later than the end of the second tax year following the end of a tax year in which you received an advance payment if, on the last day of your tax year, you meet the following conditions:

1) You account for advance payments under the alternative method discussed above in *Inclusion in income;* and
2) You have received substantial advance payments, discussed later, on the agreement; and
3) You have on hand or available to you through your normal source of supply in that year enough substantially similar goods to satisfy the agreement.

If you meet these conditions, then by the end of the second tax year after the year in which you received substantial advance payments, you must include in income all advance payments you have received to date that have not already been included in income under your accrual method of accounting for advance payments. Also by the end of this second year, you must deduct all actual or estimated inventoriable costs of goods necessary to satisfy the contract.

Any difference between the estimated and the actual costs in fulfilling the contract must be taken into account as an adjustment to cost of goods sold when the goods are delivered. After this period, any more advanced payments received on this contract are reported in income in the year received because no further deferral is allowable on this contract.

Substantial advance payments. Under an agreement for a future sale, substantial advance payments are considered received by the end of a tax year. But the total advance payments received during the current and preceding tax years must be equal to or more than the total costs and expenditures reasonably estimated to be includible in inventory because of the agreement.

Example. You are a calendar year, accrual method taxpayer who accounts for advance payments under the alternative method. In 1987 you entered into a contract for the sale of goods that are properly includable in your inventory. The total contract price is $50,000 and you estimate that your total inventoriable costs for the goods will be $25,000. You receive the following advance payments under the contract:

1987	$17,500
1988	$10,000
1989	$ 7,500
1990	$ 5,000
1991	$ 5,000
1992	$ 5,000

Your customer asked you to deliver the goods in 1993. In your 1988 closing inventory you had enough of the type of goods specified in the contract on hand to satisfy the contract. Since the advance payments you had received by the end of 1988 were more than the inventoriable costs you estimated you would have, the payments are substantial advance payments.

All payments you receive by the end of 1990, the second tax year following the tax year in which substantial advance payments are received, are included in income for 1990. Therefore, you must include $40,000 in income for 1990, and you must include in your cost of goods sold the cost of the goods (or similar goods) on hand or, if no such goods are on hand, the estimated inventoriable costs necessary to satisfy the contract.

Because no further deferral is allowable for the contract, you must include in your gross income for each remaining year of the contract the advance payments you receive in each of those years. Any difference between the estimated costs and the costs you actually have in satisfying the contract is to be taken into account in 1993, when you deliver the goods.

Information schedule. If you use this alternative method of treating advance payments for sales of goods, you must attach to your income tax return for each tax year a statement that shows:

1) Total advance payments you received in the current tax year,
2) Total advance payments you received in earlier tax years that you have not included in income before the current tax year, and
3) Total payments you received in earlier tax years that you have included in income for the current tax year.

To change to this method of reporting your income, you must first get consent from the IRS. See Chapter 4 for more information.

Nonstock Membership Organization

A nonstock membership organization that does not distribute earnings to its members may choose to report prepaid dues as income over the period that it is liable for providing services or privileges to members because of those dues. To make this choice, the organization must use the accrual method of accounting and the period for providing services must not be more than 36 months. The organization may make this choice without first getting consent from the IRS if it is made for the first tax year in which prepaid dues are received or accrued or for the first tax year that it becomes a nonstock membership organization. The choice must be made on a timely filed return (including extensions).

8. Cost of Goods Sold

If you make or buy goods to sell, you are entitled to deduct the cost of goods sold on your tax return. You deduct these costs from your gross receipts. However, to determine these costs, you must maintain inventories.

Inventories are required at the beginning and end of each tax year for manufacturers, wholesalers, retailers, and every other business that makes, buys, or sells goods to produce income. Inventories include goods held for sale in the normal course of business as well as raw materials and supplies that will physically become a part of merchandise intended for sale.

The inventory methods described in this chapter apply to sole proprietorships, partnerships, and corporations.

Accrual accounting method required. If you must account for inventories in your business, you must use the accrual method of accounting for your purchases and sales. See Chapter 4.

Accrual method not required. Personal service businesses, such as those of doctors, lawyers, carpenters, and painters, usually are not required to use inventories. Their gross business income usually is the same as their gross receipts, and most of them use the cash method of accounting. However, if they also sell or charge for the materials and supplies that are normally used in their business or profession, they must use inventories.

Figuring Cost of Goods Sold

Add to your beginning inventory the cost of inventory items purchased during the year, including all other items entering into the cost of obtaining or producing the inventory. From this total, subtract your inventory at the end of the year. The remainder represents the cost of goods sold during the tax period. It should not include selling expenses or any other expenses that are not directly related to obtaining or producing the goods sold.

The following computation of the cost of goods sold is keyed by numbers to a discussion below of each item used in the computation.

1. Inventory at beginning of year	$30,700	
Minus: Cost of merchandise contributed to charitable organizations during the year	400	$ 30,300
Add:		
2. Merchandise (or raw materials) purchased during the year	$60,000	
3. Labor	20,000	
4. Materials and supplies	4,000	
5. Other costs	6,000	90,000
6. Cost of goods in inventory		$120,300
Subtract:		
7. Inventory at end of year		35,000
Result:		
8. Cost of goods sold		$ 85,300

1. Inventory at Beginning of Year. For a manufacturer or producer, the beginning inventory includes the total value of raw materials, work in process, finished goods, and materials and supplies used in manufacturing the goods. For merchants, it consists of merchandise held for sale, discussed in *Inventories* in Publication 538, *Accounting Periods and Methods.*

Opening inventory usually will be identical with the closing inventory of the year before. Any difference must be explained in a schedule attached to the return.

Donation of inventory. If you donate any inventory item to a charitable organization, the amount of your deductible contribution is the fair market value of the item, less the amount that would be ordinary income if you had sold the item at its fair market value on the date of gift.

Special rules apply to inventory items contributed by corporations. For more information on contributions, see *Charitable Contributions* in Chapter 29.

Costs and expenses for the contributed property that were incurred in earlier years must be removed from opening inventory. They are not a part of cost of goods sold for figuring gross income for the year of the contribution. Costs and expenses for the contributed property that were incurred in the year of the contribution are deductible as part of cost of goods sold for that year, if this treatment of costs and expenses is proper under your accounting method. If such a deduction is taken, then those costs and expenses that are incurred in the year of the contribution are not treated as resulting in a basis for the contributed property.

Example 1. You are a calendar year taxpayer who uses the accrual method of accounting. In 1989, you contributed property from inventory to a church. It had a fair market value of $600. The closing inventory at the end of 1988 properly included $400 of costs due to the acquisition of the property, and in 1988, you properly deducted $50 of administrative and other expenses attributable to the property as business expense. The amount of the charitable contribution allowed for 1989 is $400 ($600 − $200). The $200 is the amount that would be ordinary income if the contributed inventory had been sold at fair market value on the date of the gift. The cost of goods sold to be used in determining gross income for 1989 may not include the $400, which was included in opening inventory for that year.

Example 2. If, in Example 1, the contributed property had been acquired in 1989 at a cost of $400, the $400 cost of the property would be included in figuring the cost of goods sold for 1989, and the $50 of administrative and other expenses attributable to the property would be allowed as a deduction for that year. You would not be allowed any further deduction for the contributed property.

2. Merchandise or Raw Materials Purchased. For manufacturers or producers, this includes the cost of all raw materials or parts purchased for manufacture into a finished product. For merchants, it includes all merchandise bought for sale.

Trade discounts. The differences between the stated prices of articles and the actual prices you pay for them are called trade discounts. The prices you pay (not the stated prices) must be used in figuring your cost of purchases.

A dealer must record the cost of an article in inventory reduced by the amount of a manufacturer's rebate that represents a trade discount.

Cash discounts. Cash discounts are amounts your suppliers let you deduct from your purchase invoices for prompt payments. There are two methods of accounting for cash discounts. You may either credit them to a separate discount account or deduct them from total purchases for the year. Whichever method you use, you must be consistent. If you want to change your method of figuring inventory cost by valuing inventory items at net purchase price (invoice price minus cash discount), get consent from the IRS. See Publication 538.

If you credit cash discounts to a separate account, you must include this credit balance in your business income at the end of the tax year. If you use this method, do not reduce your cost of goods sold by the cash discounts.

Purchase returns and allowances. All returns and allowances must be deducted from your total purchases during the year.

Merchandise withdrawn from sale. If you withdraw merchandise for your personal or family use, you must exclude this cost from the total amount of merchandise you bought for sale. You do this by crediting the purchases or sales account with the cost of merchandise you withdraw for personal use. The amount should be charged to your drawing account. You should keep a separate account of all goods you withdraw for personal or family use.

3. Labor. Labor costs usually are an element of cost of goods sold only in a manufacturing or mining business. Merchandising concerns usually do not have labor costs that can properly be charged to cost of goods sold. In a manufacturing business, labor costs that are properly allocable to the cost of goods sold include both the direct and indirect labor used in fabricating the raw material into a finished, salable product.

Direct labor. Direct labor costs are the wages paid to those employees who spend all their time working directly on the product being manufactured. They also include a part of the wages paid to employees who work directly on the product part time, if that part of their wages can be determined.

Indirect labor. Indirect labor costs are the wages paid to employees who perform a general factory function that does not have any immediate or direct connection with making the salable product, but that is a necessary part of the manufacturing process.

Other labor. Other labor costs that are not properly chargeable to the cost of goods sold may be deducted as selling or administrative expenses. Usually the only kinds of labor costs that are properly chargeable to your cost of goods sold are the direct or indirect labor costs, and certain other costs that are treated as overhead expenses properly charged to the manufacturing process, as discussed below under *Other Costs*.

4. Materials and Supplies. Materials and supplies, such as hardware and chemicals, used in manufacturing goods are charged to cost of goods sold. Those that are not used in the manufacturing process are treated as deferred charges, deductible as a business expense when used. See Chapter 5.

5. Other Costs. Examples of other costs that are incurred in connection with a manufacturing or mining process and that are chargeable to your cost of goods sold are as follows.

Containers. Containers and packages that are an integral part of the product manufactured are a part of your cost of goods sold. If they are not an integral part of the manufactured product, their costs are shipping or selling expenses.

Freight-in. Freight-in, express-in, and cartage-in on raw materials, supplies that are used in production, and merchandise that is purchased for sale are all part of cost of goods sold.

Overhead expenses. Overhead expenses include such expenses as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision. The overhead expenses you have as direct and necessary expenses of the manufacturing operation are included in your cost of goods sold.

6. Cost of Goods Available for Sale. The total of items 1 through 5 represents the cost of the goods available for sale during the year.

7. Inventory at End of Year. The value of your closing inventory (including, as appropriate, the allocable parts of the cost of raw materials and supplies, direct labor, and overhead expenses) should be subtracted from the amount in item 6.

8. Cost of Goods Sold. When your closing inventory is subtracted from the cost of goods in inventory, the remainder is your cost of goods sold during the tax year. When you subtract your cost of goods sold from your adjusted gross receipts, the remainder is your gross profit from sales. See the illustration in Chapter 9.

Inventories

Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor in your business.

The most common kinds of inventories are:

1) Merchandise or stock in trade,
2) Raw materials,
3) Work in process,
4) Finished products, and
5) Supplies (that become a part of the item intended for sale).

The value of inventories at the beginning and end of each tax year is required to determine taxable income. To determine the value of your inventory, you need a method for ***identifying*** the items in your inventory and a method for ***valuing*** these items.

Inventory valuation rules cannot be the same for all kinds of businesses. The method you use must conform to generally accepted accounting practices used for similar businesses, and it must clearly show income. To clearly show income, you must consistently use the same inventory method from year to year.

The value of your inventory may include certain capitalized costs. These rules are explained later under *Uniform Capitalization Rules*.

Items in Inventories. Inventories include all your finished or partly finished goods and raw materials and supplies that will become a part of the merchandise you intend to sell.

The rules discussed here only apply if they do not conflict with the uniform capitalization rules.

Merchandise. You should include merchandise in your inventory only if you have title to it. You should include merchandise you purchase in inventory if title to it has passed to you, even though it is in transit or you do not have physical possession of it for some other reason. Your inventory also should include goods under contract for sale that you have not yet segregated and applied to the contract, goods out on consignment (see *Consignments* in Chapter 7), and goods that are in display rooms, merchandise mart rooms, or booths that are located away from your place of business.

In figuring gross income, if you are a manufacturer, you may be permitted to account for the sale of your product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method you use for keeping your books. Do not include the goods you have sold in your inventory.

Containers. You should include containers in your inventory if title to them has not passed to the buyer of the contents. Containers include such items as kegs, bottles, and cases, whether or not on hand and whether or not returnable. If title has passed to a buyer, you should exclude the containers from inventory. Under certain circumstances, some containers may be depreciated. See Chapter 12.

C.O.D. mail sales. If you sell merchandise by mail and intend payment and delivery to happen at the same time, title passes when payment is made. Include the merchandise in your closing inventory until the buyer pays for it.

Exclude from Inventories. You should exclude from your inventory all goods you have sold, but be sure that the title to them has passed to the buyer. Also exclude goods in your possession that are consigned to you and goods you ordered for future delivery if you do not yet have title to them. See *Consignments* in Chapter 7.

Other assets. Other assets such as land, buildings, and equipment used in your business, as well as notes and accounts receivable, and similar assets, should not be included in your inventory. Also, real estate held for sale by a real estate dealer in the ordinary course of business is not included in inventory.

Cost Identification

There are three methods of identifying items in inventory—specific identification, first-in first-out (FIFO), and last-in first-out (LIFO).

Specific identification method. The specific identification method is used to identify the cost of each inventoried item by matching the item with its cost of acquisition in addition to other allocable costs, such as labor and transportation.

If there is no specific identification of items with their costs, you must make an assumption to decide which items were sold and which remain in inventory. Make this identification by either the FIFO method, or the LIFO method.

FIFO and LIFO methods. The ***FIFO method*** assumes that the items you purchased or produced first are the first items you sold, consumed, or otherwise disposed of.

The items in inventory at the end of the year are valued as the items most recently purchased or produced. If there is intermingling of the same type of goods in your inventory so that they cannot be identified with specific invoices, you must use the FIFO method to value these items, unless you elect to use the LIFO method.

The ***LIFO method*** assumes that the items of inventory that you purchased or produced last are sold or removed from inventory first. Thus, items included in your closing inventory are considered to be those from the opening inventory plus those items acquired in the current year in the LIFO order.

The FIFO method and the LIFO method produce different results in income depending on the trend of price levels of the goods included in those inventories. In times of inflation when prices are rising, LIFO will produce a larger cost of goods sold and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, LIFO will produce a smaller cost of goods sold and a higher closing inventory. Under FIFO the reverse will be true.

Adopting LIFO method. To adopt the LIFO method, you are required to file Form 970, *Application to Use LIFO Inventory Method,* or a statement that has all the information required in Form 970. You must file the form (or the statement) with your timely filed tax return for the year in which you first use LIFO.

There are very complex rules involved in using the LIFO method that are not discussed in this publication. For more information, see the regulations under section 472 of the Internal Revenue Code.

An eligible small business may elect the simplified dollar-value LIFO method. An eligible small business is one with average annual gross receipts of $5,000,000 or less for the 3 preceding tax years. For information on this method, see section 474 of the Internal Revenue Code.

Valuing Inventory

Since valuing the items in your inventory is a major factor in figuring your taxable income, the way you value your inventory is important. The two common ways to value your inventory if you use the FIFO method are the specific cost identification method and the lower of cost or market method.

The rules discussed below apply only if they do not conflict with the uniform capitalization rules, discussed later.

For a new business using FIFO you may use either the specific cost method or the lower of cost or market method to value your inventory. You must use the same method to value your entire inventory, and you may not change to another method without the permission of the IRS.

Several pricing methods are recognized for tax purposes which you may use to figure the correct cost basis of your inventory. The dollar value that results is the cost basis of your inventory.

Specific cost identification method. The cost of merchandise you purchase during the year is the cost of acquisition in addition to costs allocable to the merchandise. If you use the specific cost identification method to figure the inventory value of merchandise, materials, or supplies, cost means:

1) The inventory price of goods on hand at the beginning of the tax year, and
2) The invoice price (and the indirect costs allocable to such goods) less appropriate discounts for goods purchased during the year.

Discounts. You may or may not deduct cash discounts at your option, but you must treat them the same way from year to year. If you do not deduct the cash discounts from your inventory costs, you must include them in your business income (see Chapter 7). Transportation or other necessary charges you have in acquiring goods are added to the net invoice price. See *Uniform Capitalization Rules,* later, for additional costs that may have to be included in the inventoriable cost of goods.

Lower of cost or market method. Lower of cost or market means that you compare the market value of each item on hand at the inventory date with its cost and use the lower value as its inventory value. Thus, if at the end of your tax year you had the following items on hand, the value of your closing inventory would be $600.

Items	Cost	Market	Whichever is lower
R	$300	$500	$300
S	200	100	100
T	450	200	200
Totals	**$950**	**$800**	**$600**

If you use this method, you must value each item in the inventory. You may not value the entire inventory at cost ($950) and at market ($800) and use the lower figure. If you use the specific cost method, the value of your closing inventory would be $950.

Market value. Under ordinary circumstances and for normal goods, market value means the usual bid price at the date of your inventory. This price is based on the volume of merchandise you usually buy. Thus, if you buy items in small lots at $10 an item and a competitor buys identical items in larger lots at $8.50 an item, your usual market price will be higher than your competitor's.

The lower of cost or market rule applies to goods purchased and on hand, and to basic elements of cost (direct materials, direct labor, and an allocable share of indirect costs) of goods in process of manufacture and finished goods on hand. It does not apply to goods on hand or in process of manufacture for delivery at fixed prices on a firm sales contract (that is, not legally subject to cancellation by either you or the buyer). These goods must be inventoried at cost.

Lower than market. When, in the regular course of business, you have offered merchandise for sale at prices lower than market, the inventory may be valued at these prices, less the direct costs of disposition. Figure these prices from the actual sales for a reasonable period before and after the date of your inventory. Prices significantly different from the actual prices determined are not acceptable.

No market exists. If no market exists, or if quotations are given without reference to actual conditions because of an inactive market, you must use whatever evidence of a fair market price is available, at the dates nearest your inventory date. This evidence could include specific purchases or sales you or others made in reasonable volume and in good faith, or compensation paid for cancellation of contracts for purchase commitments.

Unsalable goods. Unsalable goods are goods in your inventory that you cannot sell at normal prices or in the usual way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange. You should value these goods at selling prices minus direct costs of disposition no matter what method you use to value the rest of your inventory. If these goods consist of raw materials or partly finished goods held for use or consumption, they must be valued on a reasonable basis, considering the usability and condition of the goods. Do not value them for less than scrap value.

Perpetual or book inventories. You may figure the cost of goods on hand with perpetual or book inventories if you use sound accounting practices. Inventory accounts, however, must be charged with the actual cost of goods purchased or produced, and credited with the value of goods used, transferred, or sold. Credits must be figured on the basis of the actual cost of goods acquired during the year and the inventory value at the beginning of the year.

Physical inventories. You must take physical inventories at reasonable intervals and the book figure for inventory must be adjusted to agree with the actual inventory.

Practices not approved. The following are some of the inventory practices that are not recognized for tax purposes:

1) Deducting a reserve for price changes or an estimated amount for depreciation in the value of your inventory,
2) Taking work in process or other parts of your inventory at a nominal price or less than its full value,
3) Omitting part of your stock on hand,
4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock,
5) Including stock in transit, shipped either to or by you, the title to which you do not hold,
6) Dividing indirect production costs into fixed and variable production cost classifications and then allocating only the variable costs to cost of goods produced while treating fixed costs as period costs that are currently deductible (the direct cost method), or
7) Treating all or almost all indirect production costs (whether fixed or variable) as period costs that are currently deductible (the prime cost method).

Gains and losses. If items included in inventory are damaged by a fire or other casualty, or are stolen, a casualty or theft loss may result. See *Loss of inventory* in Chapter 25. Any loss from casualty or theft is reflected in the cost of goods sold.

Sale of entire inventory. You must include the total amount you receive from the sale of your entire inventory on your return as ordinary income. For the sale of your entire inventory, such as when you sell or dispose of your business, see Chapter 27.

Uniform Capitalization Rules

Under the uniform capitalization rules, you are required to capitalize direct costs and an allocable portion of most indirect costs that benefit or are incurred because of production or resale activities. This means that certain expenses you have during the year will be included in the basis of property you produce or in your inventory costs, rather than claimed as a current deduction. You will recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

You are subject to the uniform capitalization rules if you:

1) Produce real property or tangible personal property for use in a trade or business or an activity engaged in for profit,
2) Produce real property or tangible personal property for sale to customers, or
3) Acquire property for resale, but not personal property if your average annual gross receipts are not more than $10,000,000.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Property produced for you under a contract is treated as produced by you to the extent that you make payments or otherwise incur costs in connection with the property.

Tangible personal property includes films, sound recordings, video tapes, books, artwork, photographs, or similar property.

For information about how the capitalization rules apply to certain inventory methods, see *Uniform Capitalization Rules* in Publication 538, *Accounting Periods and Methods.*

Property excluded from rules. The uniform capitalization rules do not apply to the following types of property:

1) Property used for personal or nonbusiness purposes,
2) Costs paid or incurred by an individual (other than as an employee) or a qualified employee-owner of a personal service corporation in the business of being a writer, photographer, or artist,
3) Property you produce under a long-term contract,
4) Personal property you purchase for resale if your average annual gross receipts are $10,000,000 or less. See *Retailers and Wholesalers,* later,
5) Property produced for your use if substantial construction had occurred before March 1, 1986.

The general uniform capitalization rules are explained in Chapter 6. The following discussion explains how these rules apply to certain inventory methods.

Simplified Production Method

If you produce inventory, you may use a simplified method to account for the additional costs that you must allocate. The method can be used for:

1) Stock in trade or other property properly included in your ending inventory.
2) Property held by you primarily for sale to customers in the course of your trade or business.
3) Property you construct for use in your trade or business if you also produce inventory property, or property in (1) or (2), and the property constructed is substantially identical to, and is produced in the same manner as, the inventory property or other allowed property.
4) Property you construct for use in your trade or business if you normally produce this property on a routine and repetitive basis.

The simplified production method is designed to lessen the burdens of complying with the uniform capitalization rules in situations where mass production of assets occurs on a repetitive and routine basis, with a typically high "turnover" rate for the produced assets. Therefore, the method is not appropriate for use in accounting for casual or occasional production of property.

You cannot use this method for property acquired for resale or property produced under a long-term contract. If a single trade or business consists of operations that include both the production of property and the acquisition of property for resale, the simplified production method must be applied to all operations of the particular trade or business. However, you do not have to use the simplified production methods for items (3) and (4) in the list.

For more information on the simplified production method, see section 1.263A-1T(b)(5) of the Income Tax Regulations.

Simplified Service Cost Method

A simplified method is also available for figuring the amount of certain indirect costs that producers must allocate to inventory production. The simplified service cost method provides for allocating administrative, support, and service costs that directly benefit or are incurred because of the performance of production activities but also benefit other activities of the producer ("mixed service costs").

If you are a producer, you can elect the simplified service cost method whether or not you use the simplified production method. Therefore, you may determine your inventoriable mixed service costs under the simplified service cost method, and then allocate these costs to your production activities under the general provisions of the uniform capitalization rules. However, if you use the simplified production method, then the inventoriable mixed service cost is allocated under that method. You may use the simplified service cost method only for the type of properties for which the simplified production method can be used.

Retailers and Wholesalers

Retailers and wholesalers (resellers) acquiring real or personal property for resale are subject to the capitalization rules in basically the same way as manufacturers and other producers. However, resellers may use one of the simplified resale methods, discussed later, for costs required to be capitalized.

The allocation rules that apply to production activities apply to those resellers that acquire property for resale and do not use a simplified resale method. Thus, resellers that do not use a simplified resale method, must allocate the additional costs required by the capitalization rules with the same degree of specificity as was required of manufacturers of inventory under prior law. In addition, these resellers may not use the various allocation methods or expedited procedures under a simplified resale method, but must use the methods and procedures allowed for the production of property under the general uniform capitalization rules including the same categories of costs.

Property acquired for resale includes the type of properties for which the simplified production method, discussed earlier, may be used. In addition, property acquired for resale may be real property or personal property (tangible or intangible). Thus, property held for sale may include:

1) Literary, musical, or artistic compositions; stocks, certificates, notes, bonds, debentures, or other evidences of indebtedness,
2) An interest in, or right to subscribe to or purchase any of the above items, and
3) Other intangible property.

$10 million gross receipts exception. The uniform capitalization rules for personal property acquired for resale do not apply if the reseller's average annual gross receipts for the 3 preceding tax years are $10,000,000 or less. The $10,000,000 test is not available for real property acquired for resale. For information on how to determine the amount of gross receipts, see section 1.263A-1T(d)(2) of the Income Tax Regulations.

Costs required to be capitalized. The costs required to be capitalized for property acquired for resale, include the following categories of costs, whether or not a simplified resale method is elected.

1) Off-site storage or warehousing ("storage") costs, such as rent or depreciation, insurance premiums, and taxes that can be attributed to a warehouse and wages of warehouse personnel. For retailers, only the costs incurred at storage sites away from the retail sales facility must be included in inventory. The costs of storing goods at the retail sales facility do not have to be included in inventory.
2) Purchasing costs, such as the wages or salaries of employees responsible for purchasing.
3) Handling costs which include processing, assembly, and repackaging costs incurred in processing goods while in the reseller's possession.
4) General and administrative costs (mixed service costs) allocable to the above functions.

Simplified resale methods. Resellers may elect a simplified resale method to allocate costs to property acquired for resale. The method must be applied separately to each trade or business of the reseller. In addition, the method may only be used by a trade or business that is exclusively a resale operation. It is not available to a trade or business that performs any kind of production activity (unless the production is a minimal amount). This method can be used if the property acquired for resale is produced under contract for the reseller.

Under these methods, costs required to be allocated to property acquired for resale relate to the costs incurred in purchasing, handling, and storage of such property. In addition, such costs include the general and administrative costs that can be allocated to these functions. Regulations for Internal Revenue Code section 263A provide guidelines for figuring what costs are incurred relating to these activities and the methods by which such costs allocated to the property acquired are held. See Publication 538 for more information on the simplified resale methods.

9. Gross Profit

After you have figured the gross receipts from your business (Chapter 7) and figured the cost of goods sold (Chapter 8), you are ready to figure your gross profit. Gross profit is the amount you must determine before you may take any deductions for business operations. These deductions are discussed in Part IV of this book.

Figuring Gross Profit

To figure your gross profit, you must first figure your net receipts. Do this by subtracting any "returns and allowances" from gross receipts. Returns and allowances include cash or credit refunds you make to customers, rebates, and other allowances off the actual sales price.

Next, subtract the cost of goods sold from net receipts. The result is the gross profit from your business.

However, if the sale of inventory items is not a major source of income for your business, you will not have to figure the cost of goods sold. Your gross profit will be the same as your net receipts — gross receipts minus any refunds, rebates, or other allowances. Most professions and businesses that sell services rather than products are able to figure gross profit directly from net receipts in this way.

Illustration. This is an illustration of the gross profit section of the income statement of a retail business. It shows how gross profit is figured.

Income Statement
Year Ended December 31, 1990

Gross receipts	$400,000
Minus: Returns and allowances	14,940
Net receipts	$385,060
Minus: Cost of goods sold	288,140
Gross profit	**$ 96,920**

The cost of goods sold for this business is figured as follows:

Inventory at beginning of year		$ 37,845
Plus: Purchases	$285,900	
Minus: Items withdrawn for personal use	2,650	283,250
Goods available for sale		$321,095
Minus: Inventory at end of year		32,955
Cost of goods sold		**$288,140**

Points to Check

Following are items to consider before figuring your gross profits.

Gross receipts. Even very small businesses will find it helpful to use cash registers to keep track of receipts. You should also use a proper invoicing system and keep a separate bank account for your business. At the end of each business day, make sure your records balance with your actual cash and credit receipts for the day.

Sales tax collected. Check to make sure your records show the correct amount of sales taxes.

Inventory at beginning of year. Compare this figure with last year's ending inventory. The two amounts should be the same.

Purchases. If you have taken any inventory items for your personal use — used them yourself, provided them to your family, or given them as personal gifts, etc. — be sure to remove them from the cost of goods sold. Subtract the amount from your purchases for the year.

Inventory at end of year. Check to make sure that your procedures for taking inventory are adequate. These procedures should provide you with a way of making sure that all items have been included in the inventory, and that proper pricing techniques have been used.

Avoid using adding machine tapes as the only evidence for your inventory. Inventory forms are available at office supply stores. These forms have columns for recording the description, the quantity, the unit price, and the value of each inventory item. Each page has space to record who made the physical count, who priced the items, who made the extensions, and who proofed the calculations. These forms will help satisfy you that the total inventory is accurate. They will also provide you with a permanent record to support its validity.

Inventories are discussed in Chapter 8.

Testing Gross Profit Accuracy

If you are in a retail or wholesale business, you can check the accuracy of your gross profit figure. First, divide gross profit by net receipts. The resulting percentage measures the average spread between the merchandise cost of goods sold and the selling price.

Next, compare this percentage to your markup policy. Little or no difference between these two percentages shows that your gross profit figure is accurate. A large difference between these percentages may show that sales, purchases, inventory, or other items of cost have not been figured accurately. The reason for the difference should be determined.

Example. Joe Able operates a retail business. On the average, he marks up his merchandise so that he will realize a gross profit of 33⅓% on its sales. The net receipts (gross receipts minus returns and allowances) shown on his income statement for 1990 is $300,000. His cost of goods sold is $200,000. This results in a gross profit of $100,000 ($300,000 minus $200,000). To test the accuracy of this year's results, Joe divides gross profit ($100,000) by net receipts ($300,000). The resulting 33⅓% confirms his markup policy of 33⅓%.

Additions to Gross Profit

If your business has income from a source other than its regular business operations, you must add that income to gross profit. Examples include income from an interest-bearing checking account, income from scrap sales, amounts recovered from bad debts, interest, and other kinds of miscellaneous income from your business.

Part IV
Figuring Net Income or Loss

This Part discusses business expenses that you may deduct from gross profit to find the net income or loss of your business. Business expenses are the normal and current costs of operating a business.

To be deductible, a business expense must be ordinary in your business and necessary for its operation. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be indispensible to be considered necessary.

If you have an expense that is partly for business and partly personal, you must separate the personal part from the business part. Only the business part is deductible.

10. Employees' Pay

Important Changes for 1990

Educational assistance programs and group legal services plans. The income exclusion for these benefit plans has been extended through tax years beginning before January 1, 1992.

Salaries, wages, and other forms of pay you give to employees generally are deductible business expenses. However, a deduction for salaries and wages must be reduced by any jobs credit determined for the tax year. For more information on the jobs credit, see Form 5884, *Jobs Credit.*

You cannot deduct salaries and other compensation incurred for constructing capital assets. Rather, include them in the basis of the constructed asset and recover them through depreciation allowances. See Chapter 12.

Cost of goods sold. If your cost of goods sold includes salaries, wages, or other payments for services, you cannot deduct them as a current business expense. See Chapter 8.

Employee-stockholders. Salaries of employees who are also stockholders must meet the same tests for deductibility, discussed later, as those of any other executives or employees.

The burden of proving that the payments to employee-stockholders are reasonable and for services actually performed is greater than in the case of payments to executives or employees who have little or no ownership interest in the corporation.

Payments to employee-stockholders that are not for services performed are not deductible. The payments may be distributions of dividends on stock. This is most likely to occur in a corporation with few shareholders, practically all of whom draw salaries. If the salaries of employee-stockholders are more than those ordinarily paid for similar services (particularly if the excessive payments bear a close relationship to the stockholdings of the employees), the salaries probably are not paid wholly for services performed but include distributions of earnings on the stock.

However, if the payments to an employee-stockholder of a ***closely held corporation*** are reasonable for the services performed, the corporation will not be denied a deduction merely because it has a poor history of paying dividends on its outstanding stock.

If your corporation uses an accrual method and the salary is unpaid at the end of the tax year, *Unpaid Salaries,* later in this chapter, explains how the deduction should be handled.

Relatives. You can deduct salaries and wages paid to employees who are your relatives, including your minor child, if the four tests for deductibility, discussed later, are met. However, see *Unpaid Salaries,* later in this chapter.

Payments to a beneficiary of a deceased employee. You can deduct payments you make to an employee's beneficiary because of the employee's death if the payments are reasonable in relation to past services performed by the employee. The payments must also meet the tests for deductibility, discussed next.

Tests for Deductibility

To be deductible, employees' pay must meet all of the following four tests.

Test 1.—Ordinary and necessary. You must be able to show that salaries, wages, and other payments for employees' services are ordinary and necessary expenses directly connected with your trade or business.

The fact that you pay your employees for legitimate business purposes is not sufficient, by itself, to be able to deduct the amounts as business expenses. You can deduct payments for services only if the payments are ordinary and necessary to carry on your trade or business.

Test 2.—Reasonable. What is reasonable pay is determined by the facts. Generally, it is the amount that ordinarily would be paid for these services by like enterprises under similar circumstances.

You must be able to prove that the pay is reasonable. This is based on the circumstances that exist at the time you contract for the services, not those existing when the amount of pay is questioned. If pay is excessive, you can deduct only the part that is reasonable.

Factors to be considered. You should consider these factors and any other pertinent data to determine if pay is reasonable.

1) Duties performed by the employee,
2) Volume of business handled,
3) Character and amount of responsibility,
4) Complexities of the business,
5) Amount of time required,
6) General cost of living in the locality,
7) Ability and achievements of the individual performing the service,
8) Comparison of the pay with the amount of gross and net income of the business as well as with distributions to shareholders,
9) Pay policy for all employees, and
10) Pay history of each employee.

Individual salaries. The test of whether or not a salary is reasonable must be based on each individual's salary and the services performed and not on the total salaries paid to all officers or all employees.

For example, even if the ***total amount*** of salaries you pay to your officers is reasonable, you still cannot deduct an individual officer's salary if it is not reasonable based on the items listed above.

Test 3.—For services performed. You must be able to prove that the payments were made for services actually performed.

Test 4.—Paid or incurred. You must have actually made the payments or incurred the expense during the tax year.

If you use the cash method of accounting, the expense for salaries and wages is deducted only in the year paid.

If you use an accrual method of accounting, the expense for salaries and wages is deducted when your obligation to make the payments is established and economic performance occurs (generally, as an employee performs his or her services for you). The economic performance rule is discussed under *The Accrual Method* in Chapter 4. The payments need not be made in the year the obligation exists but can be deferred to some later date. However, see *Unpaid Salaries,* later in this chapter.

Bonuses and Gifts

Bonuses. Bonuses you pay to employees are allowable deductions if they are intended as additional pay for services, not as gifts, and are paid for services actually performed. When you add bonuses to the regular salaries and other pay, the total must be reasonable for the services performed. You can pay the bonuses in cash, in property, or in a combination of both.

Gifts. If, in order to promote employee goodwill, you distribute turkeys, hams, or other merchandise of nominal value at holidays to your employees, the value of these items is not salary or wages. You can deduct the cost of these items as a business expense.

You can deduct the cost of gifts you give to your employees, but there is a $25 annual limit on the deduction for gifts to any one individual. Also, you must keep adequate records or sufficient evidence to prove your statement of gifts you make during the tax year. For information on achievement, safety, and other awards, see Chapter 2 in Publication 535, *Business Expenses*.

If you distribute cash, gift certificates, or similar items of easily convertible cash value, the value of such items is considered additional wages or salary regardless of the amount. See *Business Gift Expenses* in Chapter 15 for more information on gifts.

Loans

Loans or advances you make to an employee that you do not expect the employee to repay generally are deductible if they are for personal services actually performed, the total is reasonable when they are added to the employee's other compensation, and they meet the tests for deductibility, discussed earlier.

Below-market interest rate loans. On certain loans you make to an employee or stockholder, you may be considered to have received interest income and to have paid compensation or dividends equal to that interest. For more information, see *Below-Market Interest Rate Loans* in Chapter 6 of Publication 535.

Vacation Pay

Vacation pay is any amount you pay or will pay to your employee while the employee is on vacation. Vacation pay also includes amounts you pay an employee when the employee chooses not to take a vacation. Vacation pay does not include sick pay or holiday pay.

Cash basis taxpayers. If you are a cash basis taxpayer, you deduct vacation pay when you pay your employee.

Accrual basis taxpayers. You can deduct vacation pay earned by your employees in the year earned only if you pay it:

1) By the close of your tax year, or
2) If the amount is vested, within 2½ months after the close of the year.

If you pay it later than this, you deduct it in the year actually paid.

Unpaid Salaries

If you have a definite, fixed, and unconditional agreement to pay your employees a certain salary for a year but you defer payment of part of it until the next tax year, then under the accrual method of accounting you can deduct the entire salary in the first year if economic performance has occurred (that is, the employees performed their services in that year). If you use the cash method, only the amount actually paid in each year is deductible in that year.

If no definite prior arrangement was made, only the amount paid in the first year is deductible in that year because no fixed obligation exists to make later payments. The result is the same for the cash method and the accrual method.

Special rule for an accrual method payer. If you are an accrual method taxpayer, you cannot deduct salaries, wages, and other expenses owed to a related person (as defined in Chapter 4) until the tax year you make the payment and the amount is includible in the gross income of the person paid. This rule applies even if prior to the time the amount is includible in the gross income of the person to whom you will make the payments, that person and you cease to be related taxpayers.

Example 1. Tom Green runs a retail store as a sole proprietor. He uses a calendar year and an accrual method. He employs his brother, Bob, for a salary of $1,000 a month. Bob uses a calendar year and the cash method. At the end of December 1990, Tom accrues Bob's $1,000 December salary.

Because of a temporary cash shortage, Tom pays only $600 to Bob on January 14, 1991, paying him the $400 balance on April 1, 1991. Tom cannot deduct the $1,000 until 1991, the year Bob must include the amount in his income.

Example 2. The Lomar Corporation uses a calendar year and an accrual method of accounting. Frank Wilson, an officer in the corporation, uses the calendar year and the cash method. At the close of calendar year 1990, he owned 50% in value of the outstanding stock of the corporation. On March 4, 1991, he acquired additional shares that brought his holdings up to 51%. The corporation, at the end of December 1990, accrued $1,000 salary payable to Frank Wilson.

The Lomar Corporation paid Frank $600 on January 30, 1991, and the balance by March 13, 1991. The corporation is entitled to the $1,000 salary deduction in 1990. Frank and the Lomar Corporation were not related taxpayers at the close of Lomar's 1990 tax year.

Meals and Lodging

You generally can deduct the costs of furnishing meals and lodging to your employees if the expense is an ordinary and necessary business expense. You can usually deduct only 80% of the cost of food or beverages you furnish.

If the meals and lodging meet the three tests described later, their value is not included in the gross income of your employees. However, even if the cost of the meals meets tests (1) and (2), your deduction may be limited to 80% of your costs. See *80% Limitation* in Chapter 15.

If you have deducted the cost of these items elsewhere (for example, as part of the cost of goods sold), you cannot deduct their cost again as pay for your employees.

Although you can deduct only your ***costs*** of furnishing meals (subject to the limitations discussed above) and lodging to your employees, your employees may have to include in gross income the ***value*** of the meals and lodging furnished by you. (For this discussion, "employee" includes the employee's spouse and any of the employee's dependents.)

Tests for Exclusion of Meals and Lodging

For your employees to exclude from gross income the value of meals and lodging furnished to them without charge, the meals and lodging must meet the following tests.

Test 1. The meals or lodging must be furnished on ***your business premises.***

Test 2. The meals or lodging must be furnished for ***your convenience.***

Test 3. In the case of lodging (but not meals), the employees must be required to accept the lodging as a ***condition of their employment.*** This means that they must accept the lodging in order for them to properly perform their duties.

Noncash Payments and Fringe Benefits

You may pay your employees in cash or in other property, such as meals, lodging, inventory items, capital assets, assets used in your business, and shares of stock in your company.

You may provide other forms of pay to your employees in an indirect way, such as insurance, hospitalization, and medical care. These forms of pay are usually called fringe benefits. You can deduct them as business expenses if they meet the requirements discussed in this chapter and, when added to other forms of pay, are reasonable. For a discussion of insurance as a fringe benefit, see Chapter 17.

Education Expenses

If you pay the education expenses of your employees who are enrolled in courses that are not required for their job or are not otherwise job related, you must treat these payments as wages. The payments are includible in income and are subject to FICA, FUTA, and income tax withholding.

Educational assistance programs. The income exclusion for employer-provided educational assistance payments is extended through tax years beginning before January 1, 1992. Also, for tax years beginning after 1990, graduate-level courses can now be included as part of an educational assistance program.

Payments for educational assistance that would be includible in employees' income solely because they are more than $5,250 can be excluded if they qualify as a working condition fringe benefit, discussed later under *Exclusion of Fringe Benefits*.

Dependent Care Assistance Programs

If you pay for or provide child care or disabled dependent care services for your employees to allow them to work, you can exclude the amounts you spend for these services from their gross income, up to a maximum of $5,000 ($2,500 if your employee is married and filing a separate return). In addition, the cost of providing the excludable services is not subject to FICA, FUTA, or income tax withholding. For more information, see Chapter 2 in Publication 535.

Moving Expenses

Payments to employees as an allowance or reimbursement for the cost of moving to a new job site must be included in the employee's income, but are not considered wages for purposes of income tax withholding, FICA, or FUTA if it is reasonable to believe at the time payments are made that the employee will be allowed a deduction for moving expenses in computing income tax.

However, payments to an employee for nondeductible moving expenses are wages for purposes of income tax withholding, FICA, and FUTA. For example, if you reimburse your employee for a loss on the sale of a residence, the amount is considered wages and is subject to income tax withholding, FICA, and FUTA.

You must give your employees a statement describing any amounts paid to or on behalf of them for moving expenses. The statement must contain sufficient information to allow your employees to properly figure their allowable moving expense deduction. You may use

Form 4782, *Employee Moving Expense Information.* You must give this information to your employees by January 31 of the year after the year in which you make the payments.

Any reimbursement for moving expenses must be shown on the employee's Form W–2, *Wage and Tax Statement.*

Guaranteed Annual Wages

If you guarantee to pay certain employees full pay during the year (determined by the number of hours in your normal work year) under terms of a collective bargaining agreement, you can deduct the payments as wages, and they are subject to FICA, FUTA, and income tax withholding.

Prepaid Legal Expenses

The exclusion from employees' income for employer-provided group legal services plans is available for tax years beginning before January 1, 1992.

No exclusion is allowed to the extent that the value of the insurance against legal costs exceeds $70 per year.

Compensation For Injuries

You can deduct amounts you pay to employees for injuries, including lump-sum amounts paid or accrued, as compensation for injuries. They are limited to amounts not compensated for by insurance.

Capital Assets

If you transfer a capital asset or an asset used in your business to one of your employees as payment for services, you can deduct as wages its fair market value on the date of the transfer. The deductible amount is considered received in exchange for the asset, and gain or loss is recognized on the transfer. Gain or loss is figured on the difference between the fair market value of the asset and its adjusted basis on the date of the transfer. See Chapter 22.

Payments In Restricted Property

In general, restricted property is property that is subject to a condition that has a significant effect on its value.

If you transfer property, including stock in your company, to a person as payment for services and the property is considered substantially vested in that person, you generally have a deductible ordinary and necessary business expense. Substantially vested means that the person can transfer the property and is not subject to a risk of forfeiture; that is, the person is not likely to have to give up his or her rights in the property in the future.

The amount and the year in which you can deduct it will vary, depending in part upon the kind of property interest that you transferred. The amount you can deduct depends on the amount includible in the recipient's income. However, if the recipient is an employee, you must withhold federal income tax in order to take a deduction.

Cafeteria Plans

Cafeteria plans are written plans that allow your employees to choose among two or more benefits consisting of cash and qualified benefits.

A plan that provides for deferred compensation generally is not a cafeteria plan. However, certain profit sharing, stock bonus, and rural cooperative plans and certain plans maintained by educational institutions can be cafeteria plans even if they provide for deferred compensation.

Your cafeteria plan must meet requirements, discussed in Chapter 2 of Publication 535, in order for you to exclude the benefits from your employees' income.

Qualified benefits. A cafeteria plan may offer any qualified benefit other than scholarships and fellowship grants and the fringe benefits discussed later under *Exclusion of Fringe Benefits.* Qualified benefits include the cost of group term life insurance that is includible in gross income only because the amount of the insurance exceeds $50,000 or the insurance is on the life of the employee's spouse or children.

Nondiscrimination rules. If, in any plan year, your cafeteria plan discriminates in favor of certain employees as to eligibility to participate in the plan or as to contributions or benefits, these employees are taxed on the amount of the taxable benefits that could have been elected.

For more information on cafeteria plans and the reporting requirements, see Chapter 2 in Publication 535.

Exclusion of Fringe Benefits

You can exclude certain fringe benefits that you provide your employees from their gross income. If the fringe benefits are excludable from income, the benefits are also not subject to federal income tax withholding, social security taxes (FICA), or federal unemployment tax (FUTA). The fringe benefits that are excludable from gross income include:

1) A no-additional-cost service,
2) A qualified employee discount,
3) A working condition fringe,
4) A de minimis (minimal) fringe, and
5) Certain athletic facilities.

The value of meals you provide to your employees at an eating facility operated by you is a de minimis fringe only if the annual revenue from the facility equals or exceeds the direct operating costs of the facility.

You can exclude from your employees' gross income the value of an on-premises gym or other athletic facility you provide and operate if substantially all the use during the calendar year is by your employees, their spouses, and their dependent children.

In order to be eligible for the exclusion from gross income, certain nondiscrimination requirements apply to no-additional-cost services, qualified employee discounts, and employee eating facilities. For more information on fringe benefits, see Chapter 3 in Publication 535.

Employee Benefit Plans

An employee benefit plan can be set up either to provide retirement benefits or to defer compensation. If it is set up to provide retirement benefits, it can be funded entirely by the employer or by a mix of employer and employee contributions. Employee contributions can be mandatory or voluntary. A plan may also allow ***elective deferrals,*** in which employees agree to a reduction of their current compensation in return for additional employer contributions to their benefit plan. In general, a sole proprietor or partner is considered an employee for purposes of participating in a plan.

Compensation is deferred when payments for services are accumulated to provide benefits at some future date. If a plan is set up to defer compensation, the employees do not necessarily need to wait until retirement to begin receiving benefits.

Among the various types of employee benefit plans are qualified employee benefit plans, nonexempt trusts and annuity plans, self-employed retirement plans, and simplified employee pensions. Also, in general, individuals who work can set up individual retirement arrangements (IRAs).

Employer contributions capitalized. You cannot currently deduct employer contributions to an employee benefit plan or any other expenses that you are required to capitalize (include in the basis of certain property or in inventory costs). See *Costs required to be capitalized,* in Chapter 8.

Qualified Employee Benefit Plans

A qualified employee benefit plan is a written plan that you, as an employer, establish for the exclusive benefit of your employees and their beneficiaries. Contributions to the plan may be made by you, your employees, or both. You can deduct your contributions to the plan when you make them (except for any amount capitalized). Your employees generally are not taxed on your contributions or increases in the plan's assets until they are distributed to them. However, certain loans made from qualified employer plans are treated as distributions to employees or beneficiaries who receive the loans, and may result in taxable income to them.

Qualification rules. To be a qualified plan, the plan must meet many requirements. Among these are rules concerning who must be covered by the plan, how much of an employee's interest in the plan must be guaranteed, how contributions to the plan are to be invested, and how contributions to the plan and benefits under the plan are to be determined. Most qualified plans must operate through an exempt trust. For more information, get Publication 560, *Retirement Plans for the Self-Employed.*

Types of qualified plans. There are two basic types of qualified employee benefit plans: defined contribution plans and defined benefit plans.

Defined contribution plans. These are plans that provide for a separate account for each person covered by the plan. Benefits are based only on amounts contributed to or allocated to each account.

There are three types of defined contribution plans: profit-sharing plans, stock bonus plans, and money purchase pension plans.

Profit-sharing plan. This is a plan that lets your employees or their beneficiaries share in the profits of your business. The plan must have a definite formula for allocating the contributions to the plan among the participating employees and for distributing the funds in the plan.

Stock bonus plan. This plan is similar to a profit-sharing plan. Benefits under the plan are payable in the form of the company's stock.

Money purchase pension plan. Under this plan, your contributions are a stated amount, or are based on a stated formula that is not subject to your discretion, such as 10% of each participating employee's compensation. Your contributions to the plan are not based on your profits.

Defined benefit plans. These are any plans that are not defined contribution plans. In general, a qualified defined benefit plan must provide for set benefit amounts. Your contributions to the plan are not based on your profits.

Plan approval. The Internal Revenue Service (IRS) will issue a determination or opinion letter regarding a plan's qualification. The determination or opinion of the IRS will be based on how the plan is written, not on how it operates. It is not necessary for you to request a letter to get all the tax benefits of a plan.

The IRS charges a fee for determination, opinion, and ruling letters.

Master and prototype plans. It may be more convenient for you to adopt an already existing master or prototype retirement plan than to set up your own original plan. Master and prototype plans may be sponsored only by trade or professional organizations, banks, insurance companies, or mutual funds. The sponsor usually will have applied for, and received, an opinion letter on the plan form from the IRS. This does not mean that your plan is automatically qualified. It still must meet all of the qualification requirements stated in the tax law.

Nonexempt Trusts and Annuity Plans

You can deduct contributions made to a nonexempt trust or premiums paid under a nonqualified annuity plan. Your employees must include the contributions or premiums in their gross income generally according to the ***restricted property rules,*** discussed earlier.

In general, if your employee's interest in the contributions or premiums is transferable or is not subject to a substantial risk of forfeiture (that is, there is not much of a risk that the employee will lose his or her interest), the employee must include the contributions or premiums in gross income.

You deduct your contributions to the plan (except for any amount capitalized) in the tax year in which any of your employees must include an amount attributable to the contributions in gross income. You can deduct contributions only if you maintain separate accounts for each participating employee.

Therefore, if an employee's interest in your contributions for that employee is transferable or if it is not subject to a substantial risk of forfeiture when you make them, the employee must include those amounts in gross income for the tax year in which you make them. However, if, when you make the contributions, the employee's interest in the trust or in the value of the annuity contract is not transferable and it is subject to a substantial risk of forfeiture, the employee must include that interest in gross income for the tax year in which the interest becomes transferable or is no longer subject to a substantial risk of forfeiture.

Retirement Plans for the Self-Employed

If you are a self-employed person, you can be covered by certain qualified employee retirement plans (see *Qualified Employee Benefit Plans*, earlier). These plans are known as Keogh or HR–10 plans. You can also be covered by another kind of retirement plan, see *Simplified Employee Pension (SEP)*, later.

A Keogh or HR–10 plan can only be set up by an employer, a sole proprietor or partnership (but not a partner). It includes coverage for a self-employed person and must be for the benefit of employees or their beneficiaries. Generally, you can deduct contributions to the plan, and they are not taxed to your employees until distributed to them. For this purpose, a self-employed person is both an employer and an employee.

Deduction of Contributions for Yourself

To take a deduction for employer contributions made on your behalf to a plan, you must have net earnings (without regard to that deduction) from the trade or business for which the plan was established.

Net earnings. Your net earnings must be from self-employment in a trade or business where your personal services are a definite factor in producing income. Therefore, if you are a partner who only contributed capital, and who did not perform personal services, you cannot participate in the partnership's plan. Your net earnings do not take into account tax-exempt income or deductions related to that income.

The amount of your net earnings is your business gross income minus allowable deductions from that business. Allowable deductions include contributions to the plan for your common-law employees along with your other business expenses. If you are a partner, the amount of your net earnings is your share of the partnership net income including any draw or salary you receive. For more information, see *Partners* under *Self-Employment Income* in Publication 533, *Self-Employment Tax*.

Adjustment. You must reduce your net earnings by the income tax deduction you are allowed for one-half of the self-employment tax. Also, net earnings must be reduced by the deduction for employer contributions made on your behalf. This reduction is made indirectly as explained next.

Net earnings reduced by adjusting contribution rate. To reduce net earnings by the employer deduction for contributions for yourself, an adjustment must be made. This adjustment presents a problem because the amount of the deduction and the amount of net earnings depend on each other. You can make this adjustment to net earnings indirectly by reducing the contribution rate called for in the plan for contributions made for yourself. See *Figuring the deduction*, later.

Limit on deduction. If the Keogh plan is a profit-sharing plan, your deduction of employer contributions for yourself is limited to the smaller of $30,000 or 15% (reduced to 13.0435%) of your net earnings from the trade or business that has the plan. If the plan is a money purchase plan, the deduction is limited to the smaller of $30,000 or 25% (reduced to 20%) of your net earnings. The deduction limit for contributions to a defined benefit plan may be greater, but actuarial calculations are needed to determine the amount. For more information on the kinds of plans, see *Kinds of Plans* in Publication 560, *Retirement Plans for the Self-Employed.*

Figuring the deduction. To figure the deduction for employer contributions made on your behalf, net earnings from self-employment is computed with regard to the deduction allowed to you for one-half of the self-employment tax and with regard to the deduction for contributions on your behalf to the plan.

To figure your net earnings and your deduction for contributions on your own behalf, use the following worksheet:

1) Plan contribution rate shown as a decimal	______
2) Rate in (1) plus 1	______
3) Reduced rate for self-employed person (divide (1) by (2))	______
4) Net earnings (if more than $209,200, see Publication 560) reduced by one-half of your self-employment tax, but not reduced by the employer deduction for contributions on your behalf	$______
5) Deduction for contributions on your behalf (multiply (4) by (3); but do not enter more than $30,000)	$______

Example. You are a sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your net earnings, and 10½% of your common-law employees' pay. Your net earnings is $200,000. In figuring this amount, you deducted your common-law employees' pay of $60,000, contributions for them of $6,300 (10½% × $60,000), and the deduction allowed to you for one-half of your self-employment tax. Using the worksheet, you figure your deduction (amounts rounded to next dollar) for employer contributions on your behalf as follows:

1) Plan contribution rate shown as a decimal	.105
2) Rate in (1) plus 1	1.105
3) Reduced rate for self-employed person (divide (1) by (2))	.095023
4) Net earnings (if more than $209,200, see Publication 560) reduced by one-half of your self-employment tax, but not reduced by the employer deduction for contributions on your behalf	$200,000
5) Deduction for contributions on your behalf (multiply (4) by (3); but do not enter more than $30,000)	$ 19,005

Setting up the plan. To set up a Keogh plan, you may adopt a standard form of plan (master or prototype), defined below, that is sponsored by certain banks, insurance companies, mutual funds, and trade or professional organizations. This standard form of plan should have received prior IRS approval.

Master plan. A master plan has a single trust or custodial account. If you adopt a master plan, you use the single trust or custodial account along with other employers adopting the plan.

Prototype plan. A prototype plan has separate trusts or custodial accounts for each employer who adopts the plan.

Due to the many qualifying rules and tests, you should seek professional assistance if you plan to set up a specially designed plan.

When to deduct. If you make a contribution to a qualified plan after the close of your tax year but by the due date of your return, including extensions, you can deduct the contribution for that year (except for any amount capitalized), if all other requirements are met.

Additional information on retirement plans for the self-employed and on the reporting forms that must be filed for these plans can be found in Publication 560.

Individual Retirement Arrangements (IRAs)

You can set up and make contributions to an individual retirement arrangement (IRA) if you received taxable ***compensation*** and have not reached age 70 1/2 by the end of the year. You can have an IRA whether or not you are covered by any other retirement plan.

Compensation. Compensation includes taxable wages, salaries, commissions, bonuses, tips, professional fees, self-employment income (subject to certain adjustments, discussed below, and providing your personal services are a material income producing factor), other amounts received for personal services, and taxable alimony and separate maintenance payments. If you are self-employed (a sole proprietor or partner) compensation is the net earnings of your trade or business (self-employment income) taking into account the deduction for contributions on your behalf to self-employed retirement plans and the deduction allowed for one-half of your self-employment tax.

Compensation does ***not*** include income from property, such as rental, interest, or dividend income. Compensation does ***not*** include any amount received as a pension or annuity, or as deferred compensation.

Foreign earned income and other amounts that are excluded from gross income are ***not*** compensation for IRA purposes.

Contributions. The most you can contribute for any year to your IRA is the smaller of:

- $2,000, or
- Your taxable compensation.

Deductible and nondeductible contributions. Generally you can take a deduction for the contributions you are allowed to make to your IRA. However, if you or your spouse is covered by an employer retirement plan at any time during the year, your IRA deduction may be reduced or eliminated, depending on your filing status and the amount of your income. Whether or not your allowable contributions are deductible, you can choose to make nondeductible contributions to your IRA. For details on these and other rules, as well as general information on IRAs, get Publication 590, *Individual Retirement Arrangements (IRAs)*.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written arrangement (a plan) that allows an employer to make contributions toward his or her own (if a self-employed individual) and employees' retirement without becoming involved in more complex retirement plans. A SEP requires an IRA (a SEP-IRA) be set up for, at a minimum, each qualified employee. A self-employed person is an employee for this purpose.

Employer contributions. You, as an employer, can contribute (and deduct) each year to each employee's SEP-IRA up to the smaller of $30,000 or 15% of the employee's ***compensation*** (determined without regard to your contributions to the employee's SEP-IRA). SEP contributions you make to your SEP-IRA, because a special computation is required, are limited to 13.0435% of your compensation. See *Figuring the deduction* under *Retirement Plans for the Self-Employed,* earlier. Your contributions are not included in a participant's income when contributed.

Your employees cannot take a deduction for your SEP contribution.

If you have both a SEP and a profit-sharing plan, you must reduce the 15%-of-compensation deduction limit for the profit-sharing plan by the SEP deductions. If your business has a SEP, a defined contribution plan, and a defined benefit plan, you must reduce the 25%-of-compensation deduction limit for combinations of qualified plans by the SEP deductions.

Participants can also make contributions of up to $2,000 to their SEP-IRAs independent of your SEP contributions. The portion of the contributions that is deductible may be reduced or eliminated because he or she is covered by an employer retirement plan (the SEP plan). See Publication 590 for details.

Salary reduction arrangement. A SEP can include a salary reduction (elective deferral) arrangement. Under the arrangement, employees can elect to have you contribute part of their income to their SEP-IRAs. Only the remaining portion of the employees' pay is taxable. The tax on the contribution is deferred. Thus, this choice is called an ***elective deferral.***

This election is available only if:

- At least 50% of your employees eligible to participate choose elective deferrals,
- You had no more than 25 eligible employees at any time during the preceding year, and
- The amount deferred each year by each eligible ***highly compensated employee*** as a percentage of pay (deferral percentage) is no more than 125% of the average deferral percentage of all nonhighly compensated eligible employees (ADP test). Income in excess of $209,200 (indexed for 1990) cannot be considered in figuring an employee's deferral percentage. The term "highly compensated employee" is defined in Publication 590.

Limits on deferrals. In general, the total income an employee can defer under a salary reduction arrangement included in a SEP and certain other elective deferral arrangements for 1990 is limited to $7,979. This limit applies only to the amounts that represent a reduction from the employee's income, not to any contributions from employer funds.

Elective deferrals, not exceeding the ADP test, are not included in an employee's income in the year of deferral, but are included in wages for social security tax (FICA) and unemployment tax (FUTA) purposes.

Employer's SEP contributions excluded from employee's wages on Form W-2. Your SEP contributions are excluded from your employees' income. Therefore, do not include these contributions in your employees' wages on Form W-2, *Wage and Tax Statement,* for income or social security tax purposes. However, your SEP contributions ***under a salary reduction arrangement*** are included in your employees' Form W-2 wages for social security tax purposes only.

Example. In 1990, Jim chooses to have $5,000 taken out of his pay to fund employer contributions to his SEP-IRA. His compensation for the year is $30,000. On Jim's Form W-2, his employer will show total wages of $25,000 ($30,000 minus $5,000) and social security wages of $30,000. Jim will report $25,000 as wages on his tax return.

For more information on employer withholding requirements, get Publication 937, *Business Reporting.*

For more information on SEPs, get Publication 590.

Filing Requirements

For information on the forms that must be filed for retirement plans, get Publication 560.

11. Rent Expense

If you lease business property, you generally can deduct the rent you pay. You can also deduct certain other expenses as rent. This chapter explains when you can take these deductions. If you lease a car for 30 days or more for use in your business, see *Leasing a Car* in Publication 917, *Business Use of a Car.* If you lease business property and incur a casualty loss on the leased property, see *Leased Property* in Chapter 25.

Rent

Rent is the amount that you have to pay for the use of property that you do not own. In general, you can deduct rent as an expense only if the rent is for property that you use in your trade or business. If you have or will receive equity in or title to the property, the rent is not deductible.

Rent on a personal residence. If you rent rather than own a home and use part of your home as your place of business, you can deduct the rent you pay for that part, if you meet the requirements for business use of your home. For more information, see *Use Tests* in Publication 587, *Business Use of Your Home.*

Rent paid in advance. If you pay rent in advance, you can deduct only the amount that applies to your use of the rented property during the tax year in which payment was made. The balance can be deducted only over the period to which it applies.

Example 1. In May 1990, you leased a building for 5 years, beginning July 1, 1990, and ending June 30, 1995. According to the terms of the lease, your rent is $12,000 per year. You paid the first year's rent ($12,000) on June 2, 1990. On your income tax return for calendar year 1990, you can deduct only $6,000, (6/12 × $12,000) for the rent applicable to 1990.

Example 2. In January 1990, you leased property for 3 years for $6,000 a year. You paid the full $18,000 (3 × $6,000) during the first year of the lease. For 1990, you can deduct only $6,000, the part of the rent that applies to 1990. You can deduct the balance ($12,000) over the remaining 2-year term of the lease, at $6,000 each year.

Lease or purchase. To determine if your payments are rent, you must first determine if your agreement is a lease or a conditional sales contract. If under the agreement, you acquired or will acquire title to or equity in the property, the agreement should be treated as a conditional sales contract. Payments made under a conditional sales contract are not deductible as rent expense.

Whether the agreement is a lease or a conditional sales contract depends upon the ***intent of the parties.*** Intent is determined based upon the facts and circumstances existing at the time the agreement is made.

Determine the intent. In general, an agreement can be considered a conditional sales contract rather than a lease if any of the following is true:

1) The agreement applies part of each "rent" payment toward an equity interest that you will receive.
2) You get title to the property after making all the required payments.
3) You must pay an amount close to the price of the property over a short part of the expected useful life of the property and you may continue to use the property for an additional amount of time approximating the remaining estimated useful life of the property for nominal payments.
4) You pay rent that is much more than the current fair rental value for the property.
5) You have an option to buy the property at a price that is small compared to the value of the property at the time you may take advantage of the option. Determine this value at the time of the agreement.
6) You have an option to buy the property at a price that is small compared to the total amount you are required to pay under the lease.
7) The lease designates some part of the "rent" payments as interest, or part of the "rent" payments is easy to recognize as interest.

Finance leases. Although the finance leasing rules have been repealed, farmers can continue to deduct payments made on a finance lease even if it would be considered a sale under any of the above situations. The finance lease rules apply to leases on farm property entered into after July 1, 1982, and before January 1, 1988.

Leveraged leases. Leveraged leases generally involve three parties: a lessor, a lessee, and a lender to the lessor. Usually, the lease covers a large part of the useful life of the leased property, and the lessee's payments to the lessor are enough to cover the lessor's payments to the lender.

If you plan to take part in what appears to be a leveraged lease, you may want to get an advance ruling. The following Revenue Procedures contain the guidelines to determine if a leveraged lease is a lease for federal income tax purposes.

Revenue Procedure 75-21, 1975-1 C.B. 715
Revenue Procedure 75-28, 1975-1 C.B. 752
Revenue Procedure 76-30, 1976-2 C.B. 647
Revenue Procedure 79-48, 1979-2 C.B. 529
Revenue Procedure 81-71, 1981-2 C.B. 731

Some of these guidelines are:

1) The lessor must risk a minimum unconditional investment in the property during the entire lease;
2) The lessee may not have a contractual right to buy the property from the lessor at less than fair market value at the time the right is exercised;
3) The lessee may not invest in the property, except as provided by Revenue Procedure 79-48;
4) The lessee may not lend any money to the lessor to buy the property; and
5) The lessor must have a profit motive.

The IRS may charge you a ***user fee*** for issuing a tax ruling. See Publication 1380, *User Fees,* for more information.

Leveraged leases of limited use property. The Internal Revenue Service will not issue advance rulings on leveraged leases of so-called limited use property. Limited use property is property not expected to be either useful to or usable by a lessor at the end of the lease term except for continued leasing or transfer to a member of the lessee group. See Revenue Procedures 76-30 and 81-71, which are mentioned earlier, for examples of property that is limited use property and property that is not limited use property.

Taxes on Leased Property

If you lease business property, you can deduct as additional rent any taxes that you have to pay to or for the lessor. When you can deduct additional rent for the lessor's real estate taxes that you pay on leased property depends on your accounting method.

Cash method. If you use the cash method of accounting, you can only deduct the taxes as additional rent for the tax year in which you pay them.

Accrual method. If you use the accrual method of accounting, you can deduct taxes as additional rent for the tax year in which you can determine:

1) That you have a liability for taxes on the leased property,
2) How much the liability is, and
3) That economic performance occurred.

The liability and amount of taxes are determined by state or local law, and also by the lease agreement. Economic performance occurs as you use the property.

Example. Oak Corporation is a calendar year taxpayer that uses the accrual method of accounting. Oak leases land for use in its business. Under local law, owners of real property become liable (it becomes a lien on the property) for real estate taxes for the year on January 1 of that year, but do not have to pay these taxes until June 1 of the next year (18 months later). This means that property owners become liable for 1989 real estate taxes on January 1, 1989, but do not have to pay them until June 1, 1990.

Under the terms of the lease, Oak becomes liable for the real estate taxes when the tax bills are issued on June 1, 1990. Oak cannot deduct the real estate taxes for 1989 as additional rent until June 1, 1990. This is when Oak's liability under the lease becomes fixed.

If, according to the terms of the lease, Oak is liable for the real estate taxes when the owner of the property becomes liable for them on January 1, 1989, but does not have to pay them until June 1, 1990, Oak will deduct the lessor's real estate taxes as additional rent on its 1989 tax return. This is the year in which Oak's liability under the lease becomes fixed.

Cost of Acquiring a Lease

You may either enter into a new lease with the lessor of the property or acquire an existing lease from another lessee. Very often when you acquire an existing lease from another lessee, in addition to paying the rent on the lease, you must pay the previous lessee a sum of money to acquire that lease.

If you acquire an existing lease on property or equipment for your business, you must amortize any amount you pay to acquire that lease over the remaining term of the lease. For example, if you pay $10,000 for an existing lease on a machine and there are 10 years remaining on the lease with no option to renew, you can deduct $1,000 each year.

Option to renew. The term of the lease for amortization purposes will include all renewal options, as well as any period for which the lessee and lessor reasonably expect the lease to be renewed, if less than 75% of the cost is attributable to the term of the lease remaining on the purchase date. In determining the term of the lease remaining on the purchase date, you do not include any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee.

Example 1. You paid $10,000 to acquire a lease with 20 years remaining on it and two options to renew for 5 years each. Of this cost, $7,000 was paid for the original lease and $3,000 was applied to the renewal options. Since $7,000 is less than 75% of the total cost of the lease of $10,000, you must amortize the $10,000 over 30 years, the remaining life of your present lease plus the periods for renewal.

Example 2. If in Example 1, the amount applicable to the original lease had been $8,000, then you would have been allowed to amortize the entire $10,000 over the 20-year remaining life of the original lease because the $8,000 cost of acquiring the original lease was not less than 75% of the total cost of the lease.

Cost of a modification agreement. If you have to pay an additional "rent" amount over part of the lease period in order to change certain provisions in your lease, you must capitalize these payments and amortize them over the remaining period of the lease. You cannot deduct the payments as additional rent even if they are described as rent in the agreement.

Example. You are a calendar year taxpayer and sign a 20-year lease to rent part of a building starting on January 1. However, before you occupy it, you decide that you really need less space. The lessor agrees to reduce your rent from $7,000 to $6,000 per year and to release the excess space from the original lease. In exchange, you agree to pay an additional rent amount of $3,000 payable in 60 monthly installments of $50 each.

You must capitalize the $3,000 and amortize it over the 20-year term of the lease. Your amortization deduction each year will be $150 ($3,000 ÷ 20). You cannot deduct the $600 that you will actually pay during each of the first 5 years as rent.

Commissions, bonuses, and fees. Commissions, bonuses, fees, and other amounts that you pay to obtain a lease on property you use in your business are capital costs. You must amortize these costs over the term of the lease.

Loss on merchandise and fixtures. If you sell merchandise and fixtures that you bought solely to acquire a lease and you have a loss on the sale, the loss is a cost of acquiring the lease. You must amortize the loss over the remaining term of the lease.

Improved leased property. If you lease property with a building or other improvement already on it, you are entitled to amortize only your cost of acquiring the lease. You cannot claim a deduction for depreciation on the building or other improvements.

Improvements by Lessee

If you add buildings or make other permanent improvements to leased property, you are only allowed to depreciate the cost of the improvements using the modified accelerated cost recovery system (MACRS). You are not allowed to amortize the cost over the remaining term of the lease.

If you do not keep the improvements when the lease is terminated, your gain or loss is based on your adjusted basis of the improvements at that time. For more information, see *Additions or improvements to property* under the discussion of MACRS in Chapter 12.

Assignment of a lease. If a long-term lessee makes permanent improvements to leased land and later assigns all lease rights to you for money, and you pay rent required by the lease, the amount you pay for the assignment is a capital investment. If the rental value of the unimproved land increased since the lease began, part of your capital investment is for that increase in the rental value, and the balance is for your investment in the permanent improvements.

The part that is for the increased rental value of the leased land is a cost of acquiring a lease, and you can only amortize it over the remaining term of the lease. You can depreciate the part that is for your investment in the building as discussed above.

Example 1. In 1989, Frank Jones leased unimproved land for 99 years and built a warehouse on it. In January 1990, immediately after the building was completed, Frank assigned all his rights in the lease to you. You paid Frank $100,000 for the assignment, and you also agreed to pay the rent for the unimproved land under the lease. The $100,000 you paid Frank is considered paid for the warehouse, which you can capitalize and depreciate.

Example 2. Assume that in Example 1 Frank had leased the land, built the warehouse in 1970, and used it in his business until he assigned the lease to you in January 1990. The rental value of the unimproved land for the remaining period of the lease increased $40,000 since the time the lease was entered into in 1970. Of the $100,000 that you paid to Frank, $40,000 is considered to have been paid for the lease and follows the rules explained earlier under *Cost of Acquiring a Lease*. Treat the balance of $60,000 as having been paid for the warehouse. You must capitalize and depreciate it as discussed earlier.

Capitalizing Rent Expenses

Under the uniform capitalization rules, you must capitalize or include in inventory all costs (direct and indirect) of producing real or tangible personal property, or in acquiring tangible or intangible property for resale. Indirect costs include amounts incurred for rent of equipment, facilities, or land.

Example 1. You rent construction equipment to build a storage facility. The rent you paid for the equipment must be capitalized as part of the cost of the building. You recover your cost by claiming a deduction for depreciation on the building.

Example 2. You rent space in a facility to conduct your business of manufacturing tools. The rent you paid to occupy the facility must be included in the cost of the tools you produce.

More information. For more information on the uniform capitalization rules, see *Uniform Capitalization Rules*, in Publication 551, *Basis of Assets*.

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12. Depreciation

If you buy business property that has a useful life of more than one year, you may be able to claim a limited amount of the cost as a section 179 deduction when you figure your business income for tax purposes. You must spread the remainder of the cost of this property and the cost of most other business property over more than one year and claim depreciation deductions over the useful life or recovery period of the property. You may only take depreciation deductions on property that is called depreciable property.

If, in an earlier year, you did not claim depreciation you were entitled to deduct, you must still reduce your basis in the property by the amount of the depreciation you did not deduct. You may not deduct the unclaimed depreciation in the current year or any later tax year. However, you may claim the depreciation on an amended return for the earlier year. An amended return must be filed within 3 years from the date you filed your original return, or within 2 years from the time you paid your tax, whichever is later. A return filed early is considered filed on the due date.

The discussion in this chapter gives you basic information on the section 179 deduction and the modified accelerated cost recovery system (MACRS) that apply to property placed in service after 1986. If you need information on the depreciation methods for property used before 1987, see Part III of Publication 534, *Depreciation*.

Generally, if you sell, exchange, or involuntarily convert depreciable property, and a gain is realized, all or a part of the gain may be ordinary income. See Chapter 23.

Two other methods, amortization and depletion, permit deductions similar to those allowed by depreciation. ***Amortization*** is a method that permits you to deduct certain capital expenditures in a way similar to depreciation. ***Depletion*** permits the owner of an economic interest in mineral deposits, oil wells, gas wells, geothermal deposits, or standing timber to deduct the cost over the economic life of the property. Depletion and amortization are explained in Chapter 13.

What Can Be Depreciated

Depreciable property is property for which depreciation is allowed. Many different kinds of property can be depreciated, as, for example, machinery, buildings, vehicles, patents, copyrights, furniture, and equipment.

Property is depreciable if it meets these requirements:

1) It must be used in business or held for the production of income.
2) It must have a determinable life and that life must be longer than one year.
3) It must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

In general, if property does not meet all three of these conditions, it is not depreciable.

Depreciable property may be ***tangible*** or ***intangible.*** Tangible property is any property that can be seen or touched. Intangible property is property, such as a copyright or franchise, that is not tangible. Depreciable property may be ***real*** or ***personal.*** Personal property is property such as machinery or equipment that is not real estate. Real property is land and generally anything that is erected on, growing on, or attached to land. However, ***land*** itself is never depreciable.

Business and Investment. You can only deduct depreciation for property that you use in your trade or business or hold for the production of income. You cannot deduct depreciation on nonbusiness property. For example, you cannot depreciate your car if you use it solely for pleasure, commuting, household trips, and other nonbusiness activities.

If you use property for both business and nonbusiness purposes, you can deduct depreciation only for the part used in your business. For example, if you use your car both for business and personal transportation, determine what percent of its use is for business and depreciate only that percent of its cost.

Passenger automobiles. For automobiles placed in service after June 18, 1984, there are dollar limits on the amount of the depreciation deductions you may claim. In addition, there are limits on the depreciation you may claim for passenger automobiles not used more than 50% in a qualified business use. A substantially equivalent limitation applies to lessees of leased cars. See Publication 917, *Business Use of a Car.*

Idle assets. You must claim depreciation on an asset usually used in your business but temporarily idle. For example, there is a temporary lack of a market for the product made with that asset. The asset is still treated as used in your business for federal income tax purposes.

Tangible property. You may deduct depreciation on tangible property only if it can wear out, decay or lose value from natural causes, be used up, or become obsolete.

Intangible property. You may depreciate intangible property if you can determine its useful life. However, you must use the straight line method. Some examples of depreciable and nondepreciable intangible property follow.

Patents and copyrights. These are two kinds of intangible property that can be depreciated. The useful life is the life granted by the government for the patent or copyright. If a patent or copyright becomes valueless in any year before it expires, your remaining undepreciated cost or other basis may be deducted in that tax year.

Agreement not to compete. An agreement not to compete is an agreement by the seller of a business not to compete with the buyer. The agreement may restrict competition for an agreed upon period of time or within an agreed upon area, or a combination of both.

Franchises, designs, drawings, and patterns. These are intangible property that may sometimes be depreciable.

Customer lists, subscription lists, location contracts, and insurance expirations. These are other kinds of intangible property that may sometimes be depreciated. To depreciate them, you must be able to determine their value separate from the value of any goodwill that goes with that business. You must also be able to determine, with reasonable accuracy, their useful life. If you can do both these things, the property may be depreciated. However, your determination must be based on the facts and cannot simply be your unsupported opinion.

Goodwill. Goodwill is not depreciable because its useful life cannot be determined.

Trademark and trade name. Costs for trademarks and trade names must be capitalized. You may not depreciate or amortize these costs.

What Cannot Be Depreciated

Some property you use in your business or hold for investment may not be depreciable in certain circumstances or the depreciation on that property may not be deductible by you.

Inventory. You may not depreciate your inventory. Inventory is property that is held primarily for sale to customers in the ordinary course of business. In some cases, it is not immediately clear whether property is a business asset or inventory. In these cases, carefully examine all the facts to see if it is depreciable property.

Containers. Containers are generally part of inventory and may not be depreciated. However, large durable containers used to ship your products may be depreciated if they have a life longer than one year; they qualify as property used in your business; and title to them does not pass to the buyer. To determine whether a container may be depreciated, you should consider:

1) Whether the sales contract, sales invoice, or acknowledgment of order indicates that you have retained title,
2) Whether the invoice treats the containers as separate items, and
3) Whether your records properly state your basis in the containers.

Manufacturing or processing businesses. If you must include depreciation as part of the cost of goods sold, you cannot deduct this depreciation again as a separate business expense on your return. See Chapter 8.

Rented property. If you pay rent on property, you cannot depreciate that property. Only the owner may depreciate it. If you make permanent improvements to the business property you rent, you may depreciate those improvements. For more information, see Chapter 11.

Land. You can never depreciate land. This generally includes the cost of clearing, grading, planting, and landscaping because these expenses are all part of the cost of land. However, you may depreciate some land preparation costs if they are so closely associated with a depreciable asset that it is possible to determine a life for the preparation costs along with the life of the asset with which they are associated.

Demolition of buildings. You cannot deduct any amount paid or incurred to demolish any structure, or any loss pertaining to the undepreciated basis of a structure. Instead, you must add these costs to the basis of the land on which the demolished structure was located.

Equipment used to build capital improvements. You cannot deduct depreciation on equipment you are using to build your own capital improvements. Depreciation on this equipment during the period of construction must be added to the basis of the improvements. See *Uniform Capitalization Rules* in Chapter 6.

Repairs and replacements. You may deduct the cost of repairs and replacements that do not increase the value of property, make it more useful, or lengthen its life. However, if a repair or replacement increases the value of the property, makes it more useful, or lengthens its life, you must capitalize and depreciate these costs. You cannot deduct these costs. See *Additions or improvements to property*, later.

Professional libraries. If you maintain a library that you use in your profession, you may depreciate the library only if its value decreases with time. You may deduct the cost of technical books, journals, and information services used in your business, that have a useful life of one year or less.

Section 179 Deduction

You may elect to treat all or part of the cost of certain qualifying property as an expense rather than a capital expenditure. You must decide for each item of qualifying property whether to deduct, subject to the yearly limit, or capitalize and depreciate its cost. If you make the election for a deduction, a limited amount of the cost of qualifying property you buy for use in your trade or business is deductible in the first year you place the property in service.

Placed in service. Property is considered placed in service when it is first ready and available for its specified use, whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity.

Deduction limit. The total cost you may elect to deduct for a tax year may not exceed $10,000. The $10,000 maximum applies to each taxpayer and not to each business operated by a taxpayer.

While the maximum amount that may be deducted is $10,000, there are certain provisions that can reduce this maximum.

Investment limit. For each dollar of cost of section 179 property placed in service in excess of $200,000 in a tax year, the $10,000 maximum is reduced (but not below zero) by one dollar.

Example. In 1990, James Smith placed in service machinery with a cost of $207,000. Since the cost of the machinery exceeds $200,000 by $7,000, he must reduce the maximum deduction allowed ($10,000) by $7,000. He is therefore entitled to a section 179 deduction for 1990 of $3,000.

Taxable income limit. The total cost that may be deducted in each tax year is limited to the taxable income from the active conduct of any trade or business during the tax year. Taxable income is figured as usual but without a deduction for the cost of any section 179 property and the deduction for half the self-employment tax. You cannot use a section 179 deduction to increase or create a net operating loss.

Any cost that is not deductible in one tax year under section 179 because of this limit may be carried to the next tax year and added to the cost of qualifying property placed in service in that tax year.

Example. Joyce Jones places in service in 1990 a machine that cost $8,000. The taxable income from her business for 1990 (determined without the cost of the machine and the deduction for half the self-employment tax) is $6,000. Her section 179 deduction is limited to $6,000. The $2,000 cost that is not allowed because of the taxable income limit can be carried to 1991.

See *Carryover of unallowable deduction* in Publication 534 for information on figuring the carryover.

Married taxpayers filing separate returns. A husband and wife filing separate returns for a tax year are treated as one taxpayer for the $10,000 maximum and for the $200,000 investment limit. Unless they elect otherwise, 50% of the cost of section 179 property, before the taxable income limit is applied, will be allocated to each.

Passenger automobiles. For passenger automobiles placed in service in 1990, your total section 179 deduction and depreciation cannot exceed $2,660 for 1990. See Publication 917 for more information.

Cost. The cost of property for the section 179 deduction does not include that part of the basis of the property determined by reference to the basis of other property held at any time by the person acquiring the property. For example, if you buy a new truck to use in your business, your cost for the section 179 deduction does not include the adjusted basis of the truck you trade in on the new vehicle.

Partial business use. When you use property for both business and nonbusiness, you are eligible to elect the section 179 deduction only if more than 50% of the property's use in the tax year the property is placed in service is for trade or business purposes. However, you must allocate the cost of the property to reflect only the business use of the property. This is done by multiplying the cost of the property by the percentage of business use. Use this adjusted cost to figure your section 179 deduction.

Example. You are married and file a joint return. You buy and place in service a machine in 1990 for $12,000 that you use totally in your business. You did not buy any other assets for use in your trade or business in 1990. Your taxable income limit for 1990 is $12,000. You may elect to deduct $10,000 in 1990. If you use the machine 60% in your business in the first year, the cost of the machine is adjusted to reflect the business use of the property, or $7,200 ($12,000 × 60%). Your section 179 deduction is limited to $7,200.

Listed property placed in service after June 18, 1984. For passenger automobiles, other transportation vehicles, home computers, cellular telephones, and certain other property placed in service after June 18, 1984, that are not used more than 50% in a qualified business use, no section 179 deduction is allowed and depreciation deductions are limited. See *Partial Business Use of Listed Property* in Part II of Publication 534.

Election. You must make an election to take the section 179 deduction. You make this election only in the first tax year the property is placed in service.

Use Form 4562, *Depreciation and Amortization,* to make your election and report your section 179 deduction. Make this election by taking the deduction on Form 4562 filed with your original tax return. The election cannot be made on an amended tax return filed after the due date (including extensions), and once made, the election can be revoked only with the consent of the Internal Revenue Service (IRS).

Qualifying property. You may claim the section 179 deduction on depreciable property that is "section 38 property" and that is bought for use in the active conduct of your trade or business. You cannot elect to deduct the cost of property held merely for the production of income. You cannot take depreciation to the extent that you elect to deduct the cost of your property.

The following property does not qualify for the section 179 deduction:

1) Property acquired by one member of a controlled group from another component member of the same group.
2) Property you acquired from another person and your basis in that property is determined in whole or in part by reference to the adjusted basis of the property in the hands of the person from whom you acquired it, or under the stepped-up basis rules for property acquired from a decedent. For information on basis, see Chapter 6.
3) Property you acquire from a related person if your relationship to the related person would result in the disallowance of losses.

The rules for disallowance of losses in a transaction between related parties are presented under the MACRS discussion of *Excluded Property* in Publication 534.

Section 38 property. This includes property used in a trade or business with a useful life of 3 years or more for which depreciation or amortization is allowable and that is:

1) Tangible personal property (not including buildings, structural components, and air conditioning or heating units),
2) Elevators or escalators you build or acquire new,
3) Other tangible property, including certain real property, used as an integral part of manufacturing, production, or extraction, or used as a research or bulk storage facility for fungible commodities for these activities,
4) Rehabilitation expenditures for qualified buildings.

For more information, see *Qualifying Property* in Part I of Publication 534.

Figuring the deduction. For 1990, the maximum section 179 deduction is $10,000 of the cost of property you buy for use in your trade or business. You decide how much of the cost of property you want to deduct under section 179. You do not have to claim the full $10,000. Any cost not deducted under section 179 may be depreciated.

If you have more than one item of property, you can allocate the deduction between the items. If you have only one item of qualifying property, and that item costs less than $10,000, such as $3,200, your deduction is limited to $3,200.

Subtract the amount you elect to deduct from the basis of the qualifying property. This adjusted basis is used to compute your depreciation deduction.

Example 1. In January 1990, you bought a $20,000 tractor and a $1,200 circular saw for use in your lumber business. Both items were placed in service in 1990. You elect to deduct the entire $1,200 for the saw and $8,800 for the tractor, a total of $10,000. This is the most you can deduct in 1990. Your $1,200 deduction for the saw has completely recovered the cost of that item. The cost of your tractor is adjusted by $8,800. Its adjusted basis is $11,200. This is figured by subtracting the amount of your section 179 deduction, $8,800, from the cost of the tractor, $20,000.

Example 2. In 1990, Just Sweets, a retail bakery, traded in two ovens with a total adjusted basis of $680 for a new oven costing $1,320. The bakery also traded a used machine with an adjusted basis of $4,500 for a new machine costing $9,000. Both new items were placed in service in 1990. Just Sweets got an $800 trade-in on the old ovens and paid $520 cash for the new oven and got a $4,800 trade-in and paid $4,200 cash for the machine. The transactions are nontaxable and no gain is recognized on the trade-ins.

The part of the basis of the equipment carried over due to the transactions ($680 for the oven and $4,500 for the machine) is not treated as cost for the section 179 deduction. However, Just Sweets may elect to deduct $4,720 ($520 and $4,200), the part of the cost of the new property not determined by reference to property traded-in.

Recapture of section 179 deduction. If you deducted the cost of qualifying property placed in service ***after 1986*** and the property is not used more than 50% in a trade or business for any tax year before the end of the property's recovery period you must include in income the benefit you got from the deduction.

Report any recapture of the section 179 deduction on Form 4797, *Sales of Business Property.*

Figure the amount to be included in income by subtracting from your section 179 deduction the depreciation that would have been allowable on the section 179 amount for prior tax years and the tax year of recapture.

Example. Paul Lamb, a calendar year taxpayer, bought and placed in service on December 1, 1988, an item of 3–year property costing $10,000. The property is not listed property. He used the property only for business in 1988 and 1989. He elected a section 179 deduction of $5,000 for this property. During 1990, he used the property 40% for business and 60% for personal use. Had he not elected to expense $5,000 in 1988, he would have been entitled to deduct $1,666.50 (33.33% of $5,000) in 1988 and $2,222.50 (44.45% of $5,000) in 1989. In 1990, he would have been entitled to deduct 40% of $740.50 (14.81% of $5,000) or $296.20. Therefore, he must include in income for 1990 the excess of $5,000 over $4,185.20 ($1,666.50 + $2,222.50 + $296.20) or $814.80.

Dispositions. If you elect the section 179 deduction, the amount deducted is treated as depreciation for the recapture rules. Thus, any gain you recognize on disposition of the property is treated as ordinary income to the extent of the amounts deducted and depreciation taken. See Chapter 23.

Installment sales. If you make an installment sale of qualifying property, any amounts deducted under section 179 are recaptured in the year of sale as ordinary income up to the gain realized on the sale. See Chapter 24.

Partnerships and S corporations. The limits apply to both the partnership and to each partner. The partnership allocates the deduction among the partners. Each partner then takes the deduction on his or her own tax return subject to the dollar limitation ($10,000 for 1990). If, for example, you have a $1,000 section 179 deduction allocated to you from a partnership, then you can deduct up to $9,000 of the cost of eligible property from your other business.

Likewise, the limits apply to an S corporation and to each shareholder. The corporation allocates the deduction among the shareholders, who then take the deduction subject to the limits.

Records. No deduction will be allowed for the use of passenger automobiles, other transportation vehicles, home computers and other listed property unless substantiated by adequate records or sufficient evidence to prove your statements. See Publication 534.

Figuring Depreciation

To figure depreciation, you generally must first determine three things about the property you intend to depreciate. They are (1) its basis, (2) the date it was placed in service, and (3) the method of depreciation you use. See *Placed in service,* earlier.

Basis

Basis is a measure of your investment in the property you own. When you depreciate property, a certain percentage of your basis in it is deducted each year.

For property that you buy, your original basis is usually its cost to you. For property that you acquire in some other way, such as by inheriting it, receiving it as a gift, building it yourself, or getting it in a tax-free exchange, you must figure your original basis in some other way.

Events will often change the basis of a piece of property. This changed basis is called the adjusted basis. Some events, such as improvements, increase basis. Some, such as casualty losses and the section 179 deduction, decrease basis. If basis is adjusted, the depreciation deduction may also have to be changed, depending on the reason for the adjustment and on the method of depreciation you are using.

Chapter 6 explains how to figure basis for property acquired in different ways, what increases and decreases basis, and how to allocate basis among assets.

Nonbusiness property changed to business use. When you change property that was not used for business to a business use, you must determine your basis in the property for figuring depreciation. This amount is determined as of the date of the change. It is the fair market value of the property on that date or, if less, your adjusted basis in the property on that date.

Modified Accelerated Cost Recovery System (MACRS)

The modified accelerated cost recovery system (MACRS), also referred to as the "General Depreciation System" or "GDS," generally applies to all tangible property placed in service after 1986. However, you could have made a property-by-property election to use MACRS for property placed in service after July 31, 1986, and before 1987. See the discussion of excluded property, later.

Property classes. Each item of property depreciated under MACRS is assigned to a property class. The property class of an item of property establishes the number of years over which the basis of the property is recovered. This period of time is called a recovery period.

Items in property classes. Under MACRS, tangible property falls into one of the following classes.

3–year property. This class includes tractor units for use over the road, any race horse over 2 years old when placed in service, and any other horse over 12 years old when placed in service. This property is depreciated over 3 years.

5–year property. This class includes trucks, computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), and any automobile. This property is depreciated over 5 years.

7–year property. This class includes office furniture and fixtures (desks, files, etc.), any property that does not have a class life, and that has not been designated by law as being in any other class. This property is depreciated over 7 years.

10–year property. This class includes vessels, barges, tugs, and similar water transportation equipment, and any single purpose agriculture or horticultural structure, and any tree or vine bearing fruit or nuts. This property is depreciated over 10 years.

15–year property. This class includes any municipal wastewater treatment plant. This property is depreciated over 15 years.

20–year property. This class includes any municipal sewers. This property is depreciated over 20 years.

Nonresidential real property. This class includes any real property which is not residential rental property (defined next) and section 1250 property with a class life of 27.5 years or more. This property is depreciated over 31.5 years.

Residential rental property. This class includes any real property that is a rental building or structure (including mobile homes) for which 80% or more of the gross rental income for the tax year is rental income from dwelling units. If you occupy any part of the building or structure, the gross rental income includes the fair rental value of the part you occupy. This property is depreciated over 27.5 years.

The class lives and recovery periods for most assets are listed in the *Table of Class Lives and Recovery Periods* in Part II of Publication 534.

Additions or improvements to property. Additions or improvements you make to any property, including leased property, are treated as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of the date the addition or improvement is placed in service or the date the property to which the addition or improvement is made is placed in service. The recovery class of the addition or improvement is the recovery class that would apply to the underlying property if it were placed in service at the same time as the addition or improvement.

MACRS deductions. You may determine your MACRS depreciation deduction in one of two ways. You can use the percentage tables discussed later. Or you can actually compute the deduction using the applicable depreciation method and convention over the recovery period. The deduction is the same under both methods.

Depreciation methods. For property in the 3–, 5–, 7–, or 10–year class, you use the double (200%) declining balance method over 3, 5, 7, or 10 years and a half-year or mid-quarter convention (defined later). For property in the 15– or 20–year class, you use the 150% declining balance method over 15 or 20 years and a half-year or mid-quarter convention. For these classes of property, you change to the straight line method for the first tax year for which that method, when applied to the adjusted basis at the beginning of such year, will yield a larger deduction. You always use the straight line method for nonresidential real and residential rental property.

Straight line election. Instead of using the declining balance method, you may elect to use the straight line method with a half-year or mid-quarter convention (defined later) over the recovery period. The election to use the straight line method for one item in a property class applies to all property in that class placed in service in the tax year of the election.

The election is made by entering "S/L" in column (f) of Part II of Form 4562. The election must be made by the due date (including extensions) for the tax return for the tax year the property for which the election is made is placed in service. You must attach a statement identifying the election by Code section (Code section 168(b)(5)) and the property for which the election is made.

Once made, the election to use the straight line method over the recovery period cannot be changed (see also *Alternate MACRS Method*, later).

150% election. Instead of using the declining balance method over the recovery period, you may elect to use the 150% declining balance method over the class life of the property. If the property does not have a class life assigned to it, the recovery period is 12 years. A half-year or mid-quarter convention is used and there is a change to the straight line method when that method will give a larger deduction. The election to use the 150% declining balance method for one item in a property class applies to all property in that class placed in service in the tax year of the election.

The election is made by entering "150 DB" in column (f) of Part II of Form 4562.

Once made, the election to use the 150% declining balance method over the class life may not be changed.

Percentage tables. The percentage tables are based on the depreciation method, recovery period, and convention. The percentages in the tables are applied to the unadjusted basis of the property each year of the recovery period. ***Unadjusted basis*** is the same amount you would use to compute a gain on a sale not reduced for any depreciation but reduced by the amount you amortize or by the amount you elect to deduct under section 179. See *Conventions*, later.

The following table has the percentages for 3–, 5–, and 7–year property. The percentages are based on the 200% declining balance method and a half-year convention with a change to the straight line method. See Part II of Publication 534 for complete tables, including tables for the mid-quarter convention.

Year	3–year	5–year	7–year
1	33.33%	20%	14.29%
2	44.45%	32%	24.49%
3	14.81%	19.2%	17.49%
4	7.41%	11.52%	12.49%
5		11.52%	8.93%
6		5.76%	8.92%
7			8.93%
8			4.46%

Example. You buy for $10,000 and place in service on August 10, 1990, an item of 7–year property. You do not elect a section 179 deduction. The unadjusted basis of the property is $10,000. You use the percentage tables to figure your deduction.

Multiply $10,000 by 14.29% to get your depreciation for 1990 of $1,429 for this item of 7–year property. For 1991, multiply $10,000 by 24.49% to get your depreciation deduction of $2,449.

Computing deductions. Instead of using the percentage tables to figure depreciation, you can actually compute the depreciation deduction each year. You must apply the appropriate convention for the first year.

Declining balance method. To figure your MACRS deduction, first determine your declining balance rate. Do this by dividing the specified declining balance percentage (150% or 200%) by the recovery period. For example, for 3–year property, you divide 2.00 by 3 to get .6667 or 66.67%. For 15–year property, you divide 1.50 by 15 to get .10 or 10%.

Multiply the adjusted basis of the property by the declining balance rate and apply the half-year convention to figure your depreciation for the first year. In the second year, first adjust your basis for the amount of depreciation allowable for the first year. Then multiply this adjusted basis by the same rate used in the first year.

Declining balance rates. The following table shows the applicable declining balance rate for each class of property and the first year for which the straight line method will give an equal or greater deduction. For 3–, 5–, 7–, and 10–year property, the rate is based on the 200% declining balance method. For 15– and 20–year property, it is based on the 150% declining balance method.

Class	Declining balance rate	Year
3	66.67%	3rd
5	40%	4th
7	28.57%	5th
10	20%	7th
15	10%	7th
20	7.5%	9th

Straight line method. To figure your MACRS deduction under the straight line method, a new depreciation rate is determined for each tax year in the recovery period. For any tax year, the straight line rate is determined by dividing the number 1 by the years remaining in the recovery period at the beginning of the tax year. The rate is applied to the unrecovered basis of the property. If the remaining recovery period at the beginning of the tax year is less than 1 year, the straight line rate for that tax year is 100%.

For example, the straight line method applied to property with a 5–year recovery period results in a straight line rate of 20% (1 divided by 5) for a full tax year. After applying the half-year convention, the first year rate is 10%. At the beginning of the second year, the remaining recovery period is 4.5 years as a result of the half-year convention. The straight line rate for the second year is 22.22% (1 divided by 4.5). This second year rate is applied to the cost or other basis of the property reduced by the depreciation taken in the first year.

Conventions. Use a half-year convention to figure the deduction for property other than nonresidential real and residential rental property. Under a special rule, you may have to use a mid-quarter convention. For nonresidential real and residential rental property, use a mid-month convention in all situations.

Half-year convention. Under MACRS, the half-year convention treats all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, on the midpoint of that tax year.

Mid-quarter convention. If during any tax year the total depreciable bases of all MACRS property placed in service during the last 3 months of that tax year exceed 40% of the total depreciable bases of all MACRS property placed in service during that tax year, use a mid-quarter convention instead of a half-year convention. In determining the total bases of the property, do not include the basis of:

Residential rental property,

Nonresidential real property, or

Property placed in service and disposed of in the same tax year.

Under a mid-quarter convention, treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, on the midpoint of the quarter.

To figure your MACRS deduction for property subject to the mid-quarter convention, first figure your depreciation for the full tax year. Then multiply by the following percentages for the quarter of the tax year the property is placed in service.

Quarter of tax year	Percentage
First	87.5%
Second	62.5%
Third	37.5%
Fourth	12.5%

See Part II in Publication 534 for more information, including percentage tables based on the mid-quarter convention.

Mid-month convention. Under a mid-month convention, treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, on the midpoint of that month.

Example. You buy a building for $100,000 and land for $20,000 which is nonresidential real property that you place in service in your business on October 7, 1990. You use the calendar year as your tax year. You do not use the tables to compute your depreciation deductions. You figure your MACRS depreciation for the building by dividing 1 by 31.5 years to get the straight line rate for a full year of 3.175%. The depreciation for a full year is $3,175 (3.175% of $100,000). Under the mid-month convention, October, the month the property is placed in service, is treated as half a month. Therefore, you would get 2.5 months of depreciation for 1990. Expressed as a percentage, 2.5 months is 20.8% (2.5 ÷ 12). Your 1990 depreciation for the building is $660 (20.8% of $3,175).

Alternate MACRS Method

If you choose, you may use the alternate MACRS method (also referred to as the "alternative depreciation system" or "ADS"). Under this method depreciation is figured using a straight line method.

- For nonresidential real and residential rental property, the straight line method is applied to a 40-year recovery period with a mid-month convention.
- For automobiles and light general purpose trucks, the straight line method is applied over a 5-year period with a half-year or mid-quarter convention.
- For single purpose agricultural and horticultural structures, it is applied over a 15-year period with a half-year or mid-quarter convention.
- For any tree or vine bearing fruit or nuts, it is applied over a 20-year period with a half-year or mid-quarter convention.

The alternate MACRS recovery period for many assets can be found in the *Table of Class Lives and Recovery Periods* in Part II of Publication 534.

Election. You make the election to use the alternate MACRS method by entering the depreciation on line 15 of Part II of Form 4562. Make the election by the due date (including extensions) for the tax return of the tax year the property is placed in service. Attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(g)(7)) and the property items for which the election is made.

The election of the alternate MACRS method for one item in a property class applies to all property in that class placed in service during the tax year of the election. However, the election applies on a property-by-property basis for nonresidential real and residential rental property.

The election to use an alternate MACRS method once made cannot be changed.

Excluded Property

You cannot use MACRS for certain property placed in service before 1987 (before August 1, 1986, if election made) that is transferred or converted from personal to business use after 1986 (after July 31, 1986, if election made). Property that does not come under MACRS must be depreciated under ACRS or one of the other methods of depreciation based on useful life, such as straight line or declining balance, discussed in Part III of Publication 534. In addition, you may elect to exclude certain property from the application of MACRS.

Election to exclude certain property. If you properly depreciate any of your property under a method of depreciation that is not based on a term of years, such as the unit-of-production method, you may elect to exclude that property from MACRS. To figure a depreciation deduction under the unit-of-production method divide the cost or other basis (less salvage) by the estimated number of units to be produced during the life of the asset. Apply the resulting amount to the units produced in a year to arrive at your depreciation for that year.

To make this election report the depreciation for the property on line 17, Part III of Form 4562, for the tax year in which your property is placed in service. Make the election by the due date (including extensions) of the tax return for the tax year the property for which the election is made is placed in service. You must attach a statement which contains your name, address, and taxpayer identification number, and identifies the election by Code section (Code section 168(f)(1)) and the property items for which the election is made.

If you use the standard mileage rate for an automobile you buy and use for business after 1980, you are considered to have elected to exclude the automobile from MACRS and ACRS. See Publication 917 for a discussion of the standard mileage rate.

Property placed in service before 1987. These excluded property rules apply to both personal and real property. However, the rules for personal property are more restrictive.

For these rules, neither real nor personal property is treated as owned before it is placed in service. Therefore, if you owned property in 1986 but do not place it in service until 1987, it is not treated as owned in 1986.

Personal property. You may not use MACRS for most personal property (section 1245 property) that you acquired after 1986 (after July 31, 1986, if MACRS was elected) if:

1) You or a party related to you owned or used the property in 1986,

2) The property was acquired from a person who owned it in 1986 and, as part of the transaction, the user of the property does not change,

3) You lease the property to a person (or a person related to this person) who owned or used the property in 1986, or
4) The property is acquired in a transaction in which the user of the property does not change and the property is not MACRS property in the hands of the person from whom it is so acquired due to (2) or (3).

Real property. For real property, other than nonresidential real property or residential rental property (real property with a class life of less than 27.5 years), placed in service after 1986 (after July 31, 1986, if MACRS was elected) you cannot use MACRS if:

1) You or a party related to you owned the property in 1986,
2) You lease the property back to the person (or a person related to this person) who owned the property in 1986, or
3) You acquire the property in a transaction in which some of your gain or loss is not recognized. MACRS applies only to the part of your basis in the acquired property that represents cash paid or unlike property given up. It does not apply to the substituted portion of the basis.

Related parties. For these rules, a party related to you includes members of your immediate family (including your spouse, ancestors, and lineal descendants).

Special rule. These excluded property rules do not apply to any property if the allowable deduction for the property for the first tax year in which the property is placed in service using ACRS is greater than the deduction under MACRS using the half-year convention.

For more information on related parties and other special rules, see Part II of Publication 534.

Form 4562

Form 4562, *Depreciation and Amortization,* is used by all taxpayers reporting depreciation, amortization, or the section 179 deduction.

File Form 4562 only if:

1) You are claiming depreciation on property placed in service this year,
2) You are claiming a section 179 deduction,
3) You are beginning to claim amortization this tax year,
4) You are claiming depreciation on any listed property, or
5) You are filing a corporate tax return.

If you do not have to file Form 4562, claim depreciation on the appropriate line of your tax return. A sample Form 4562 is illustrated in Part VIII, *Filled-In Forms.*

13. Amortization and Depletion

You may be able to deduct each year, as amortization, a part of certain capital expenses. Amortization generally allows a writeoff of your costs that are not ordinarily deductible. If you can take amortization, it is a deduction in lieu of depreciation. See Chapter 12 for information on depreciation.

If you have an exhaustible natural resource or timber, you are allowed a depletion deduction. Depletion is discussed later in this chapter.

Amortization

Amortization lets you recover certain capital expenses in a way that is like straight line depreciation. Only certain specified expenses may be amortized for federal income tax purposes. The different types of expenses that may be amortized are discussed in this chapter. For a more detailed discussion of amortization, see Chapter 10 of Publication 535, *Business Expenses.*

If you want to amortize your expenses, you must make an election to do so. Generally, the election is made by filing Form 4562, *Depreciation and Amortization,* and attaching a required statement to your income tax return. Unless otherwise indicated, you enter your deduction in Part VI, *Amortization,* of Form 4562.

Going into business. When you go into business, all costs you had to get your business started are treated as capital expenses and are a part of your basis in the business. Any costs that were for particular assets can generally be recovered through depreciation deductions. Other costs generally cannot be recovered until you sell or otherwise go out of business.

See *Going Into Business* in Chapter 5 for a discussion of how to treat these costs if you do not go into business.

However, you can elect to amortize certain costs that you have in setting up your business. These costs are deducted in equal amounts over a period of 60 months or more. To be amortizable in this way, costs must qualify in one of the following three areas:

1) Business start-up costs,
2) Organizational expenses for a corporation, or
3) Organizational expenses for a partnership.

The sections below discuss which costs qualify in each of these three areas.

Business start-up costs. Start-up costs are those that you have in setting up an active trade or business, or for investigation of the possibility of creating or acquiring an active trade or business. To be amortizable, a start-up cost must meet the following tests:

1) It must be deductible if it were paid or incurred to expand an existing trade or business.
2) It must be paid or incurred by you before you actually begin business operations.

Start-up costs ***include*** what you pay both for investigating a prospective business and getting the business started. For example, they may include costs of items such as the following:

A survey of potential markets.

An analysis of available facilities, labor supply, etc.

Advertisements for the opening of the business.

Salaries and wages for employees who are being trained, and for their instructors.

Travel and other necessary expenses for securing prospective distributors, suppliers, or customers.

Salaries and fees for executives and consultants, or for other professional services.

Start-up costs include any amounts paid or incurred in an activity engaged in for profit and for the production of income in anticipation of the activity becoming an active trade or business. To be amortizable the costs must be paid or incurred before the day on which the active trade or business begins.

Start-up costs ***do not include*** deductible interest, taxes, and research and experimental costs. See the discussion of *Research and experimental costs,* later.

Business sold. If you completely dispose of a trade or business before the end of the amortization period selected, any deferred start-up costs attributable to the trade or business that have not been deducted may be deducted to the extent they qualify as a loss from a trade or business.

Organizational costs for a corporation. Corporate organizational costs are those that are incident to the creation of the corporation. They include the cost of temporary directors, organizational meetings, state incorporation fees, and accounting services related to setting up the organization. They also include the cost of legal services, such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings.

However, costs of issuing and selling stock or securities, such as commissions, professional fees, and printing costs are not organizational costs and may not be amortized. Costs connected with the transfer of assets to the corporation also cannot be amortized or depreciated. They must be capitalized.

To qualify for amortization, an organizational cost must meet all three of the following tests:

1) It must be incident to the creation of the corporation. The cost must be incurred before the end of the first tax year in which the corporation is in business. A corporation using the cash method may amortize organizational costs incurred within the first tax year even if it does not pay them in that year.
2) It must be a cost that is chargeable to a capital account.
3) It must be one that could be amortized over the life of the corporation, if the corporation had a fixed life.

Organizational costs for a partnership. Partnership organizational costs are those that are incident to the creation of the partnership.

To be amortizable, an organizational cost must be one that is chargeable to a capital account, and it must be one that could be amortized over the life of the partnership, if the partnership had a fixed life.

Partnership organizational costs do not include syndication fees. That is, they do not include costs connected with the issuing and marketing of interests in the partnership, such as commissions, professional fees, and printing costs. These costs must be capitalized. They cannot be depreciated or amortized.

How to amortize. The costs that qualify in these three areas are deducted in equal amounts over a period of not less than 60 months. You can elect a different period for start-up and for organizational costs, as long as each is 60 months or more. Once you elect an amortization period, you cannot change it.

To figure your deductions, divide the total of your start-up or organizational costs by the number of months in the amortization period. The result is the amount that can be deducted each month.

The amortization period starts with the month you begin business operations. You can amortize only if you actually go into business. For the amortization of organizational costs, a partnership or corporation is considered to begin business operations when it starts the activities for which it is organized. This can happen either before or after the corporate charter is granted or a partnership agreement is signed. A partnership or corporation will be considered as having begun business if its activities have reached the point where the nature of its business operations can be established. For example, if it acquires the assets it needs to operate its business, this may constitute the beginning of business activities.

Making the election. If you want to amortize your costs, you must complete Part VI of Form 4562 and attach it to your income tax return. If you elect to amortize both start-up and organizational costs, in addition to furnishing all of the information that is required in Part VI, Form 4562, you must attach a separate statement to your return for each type of cost. Each statement should:

1) Show the total amount of the start-up or organizational costs you will amortize,
2) Describe what each is for,
3) Give the date each cost was incurred,
4) State the month your business began operations (or the month you acquired the business), and
5) Specify the number of months in your amortization period (not less than 60).

Each statement must be attached to your return for the tax year in which the amortization period starts, which is the first tax year that you are in business. Both the statement and the return must be filed by the due date for the return (including any extensions).

Partnerships and corporations. If your business is organized as a partnership or corporation, only the partnership or corporation can elect to amortize its start-up or organizational costs. A partner or shareholder cannot make this election.

If you as a partner or shareholder incur costs in setting up your partnership or corporation, you cannot amortize them. If the partnership or corporation does not reimburse you for these costs, it cannot amortize them either. These costs then become part of the basis of your interest in the business. You can recover them only when you sell your interest in the partnership or corporation.

However, you, as an individual, can elect to amortize the costs you incur to investigate an interest in an existing partnership. These expenses qualify as business start-up costs if you succeed in acquiring the interest.

Construction period interest and taxes. You are not allowed to deduct real property construction period interest or taxes that are paid or accrued in the tax year on property that is used in a trade or business or in an activity conducted for profit. Instead, these amounts must be capitalized. However, for amounts paid or incurred before 1987, these costs could be amortized over a 10-year period.

For more information, see Chapter 10 in Publication 535.

Research and experimental costs. Research and experimental costs may be amortized or they may be deducted as current business costs. You have the choice to deduct the costs currently as business expenses or to treat them as deferred expenses and amortize them in equal amounts over a period of not less than 60 months. See Chapter 5 for a discussion of the choice to deduct the costs.

The amortization deduction is an election that applies to those costs that are:

Paid or incurred by you in your trade or business,

Not being currently deducted, and

Chargeable to a capital account.

For more information, see section 174 of the Internal Revenue Code and the regulations.

Bond premium. Bond premium generally is the amount you pay for a bond that is greater than the amount the issuer of the bond will pay upon maturity of the bond. For taxable bonds, bond premium is determined by reference to the amount the issuer will pay upon an earlier call date if it results in a smaller amortizable bond premium attributable to the period ending on the call date. Bond premium does not include any amount attributable to the conversion features of a bond.

You must amortize the premium on tax-exempt bonds, but you may not deduct the amortizable premium in figuring your taxable income.

You may elect to amortize the premium on taxable bonds. If you do not elect to amortize the premium, it will be treated as part of your basis of the bond.

You decrease the basis of the bond by the amortizable bond premium in all cases in which you are required, or elect, to amortize the premium. This will give you the adjusted basis you will use to figure the correct gain or loss on the sale or redemption of the bond.

A ***dealer in taxable bonds*** or anyone who holds them mainly for sale to customers in the ordinary course of a trade or business and who would properly include bonds on hand in inventory at the close of the tax year cannot claim a deduction for amortizable bond premium. Instead the premium is part of the cost of the bonds.

See section 75 of the Internal Revenue Code for determining your gross income if you are a dealer in tax-exempt bonds.

For more information, see Publication 550, *Investment Income and Expenses.*

Reforestation expenses. You can elect to amortize part of the amounts you spend on forestation or reforestation of property held for commercial timber production. You can amortize your direct costs for planting or seeding, including your costs for site preparation, seeds or seedlings, labor, and tools. Only $10,000 ($5,000 for a married individual filing a separate return) of these costs in each tax year qualify for amortization. Each year's qualifying costs are amortized over an 84–month period. For more information, see *Reforestation Expenses* in Chapter 10 of Publication 535.

Pollution control facilities. You may elect to amortize the cost of a certified pollution control facility over a period of 60 months. The amortization deduction is based on the amortizable basis of any new certified pollution control facility used for a plant (or other property) that was in operation before 1976.

Certified pollution control facility. A certified pollution control facility is depreciable property that is a new identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes, or heat. It must be appropriately certified by state and federal certifying authorities.

If it appears that all or a part of the cost of a facility will be recovered from its operation such as through sales of recovered wastes, the federal certifying authority will certify to that effect, describing the nature of the potential cost recovery. The cost of the facility which may be amortized must be reduced accordingly.

Agreement not to compete. If an agreement not to compete between you and the seller accompanies the transfer of goodwill in the sale of a business, and the agreement assures you of the beneficial enjoyment of the goodwill you acquire, the agreement is considered a capital asset that, like goodwill, cannot be depreciated. However, an agreement not to compete for a fixed number of years that is not, in effect, a sale of goodwill is subject to depreciation based on its estimated useful life. If the latter applies, the deduction is entered in Part III of Form 4562.

You must establish from the facts and circumstances whether you bought goodwill or entered into an agreement not to compete.

Cost of acquiring lease. If you acquire a lease for business purposes, you may recover the cost by amortizing it over the term of the lease. The term of the lease for amortization purposes includes all renewal options (and any other period for which the lessee and lessor reasonably expect the lease to be renewed) if less than 75% of the cost is attributable to the term of the lease remaining on the acquisition date. The remaining term of the lease on the acquisition date does not include any period for which the lease may be subsequently renewed, extended, or continued under an option exercisable by the lessee.

Commissions or finders' fees. Fees paid to locate money that you can borrow, or to locate borrowers to whom you can lend, are part of the acquisition costs of the loans and are not deductible as current expenses. They must be amortized over the period for which you borrow the money.

Trademarks and trade names. For amounts paid or incurred after 1986, you may no longer elect to amortize over a 60-month period the costs of acquiring, protecting, expanding, registering, or defending trademarks or trade names. Instead, you must capitalize these costs and recover them on the disposition of the assets.

Deducting amortization. Continue to deduct amortization for trademark and trade name expenses paid or incurred before 1987 on the appropriate line of your tax return or in Part VI of Form 4562, if that form is otherwise required.

For the tax treatment of amounts that you receive on the transfer of a trademark or trade name, see Chapter 22.

Depletion

If you own mineral property, an oil, gas, or geothermal well, or standing timber, you may be able to take a deduction for depletion. The deduction may be available to you as an owner and an operator if you have an economic interest in mineral deposits or standing timber. For more information on depletion, see Chapter 11 in Publication 535.

Depletion is figured separately for each property. A property is each separate interest you own in each mineral deposit in each separate tract or parcel of land.

Individuals, estates, and trusts that claim depletion deductions may have to attach Form 6251, *Alternative Minimum Tax—Individuals,* to their return.

Figuring the Deduction

There are two ways of figuring depletion: cost depletion and percentage depletion. Percentage depletion does not apply to timber.

Cost depletion. Cost depletion is usually figured by dividing the adjusted basis of the mineral property by the total number of recoverable units in the deposit, and multiplying the resulting rate per unit:

1) By the number of units sold and for which you receive payment during your tax year if you use the cash method, or
2) By the number of units sold if you use the accrual method of accounting.

Percentage depletion. Percentage depletion is a certain percentage, specified for each mineral, of your gross income from the property during the tax year, but the deduction for depletion under this method cannot be more than 50% of your taxable income from the property, figured without the deduction for depletion.

Caution. For tax years beginning after December 31, 1990, the depletion deduction for oil and gas properties cannot be more than 100% of the taxable income from the property figured without the depletion deduction.

The use of percentage depletion for oil and gas wells is not allowed except for certain domestic production. If you are a qualified independent producer or royalty owner of oil and gas (see small producers, discussed later under *Oil and Gas Wells*), the deduction for depletion may not be more than 65% of your taxable income (figured without certain deductions).

Rents and royalties (which are depletable income to the payee) you pay or incur for the property must be excluded from your gross income from the property when figuring your percentage depletion.

50% limit. In figuring the percentage depletion deduction and the 50% limit for percentage depletion, you reduce your gross income from the property by the allocable part of any bonus you paid for a mineral lease or an oil and gas lease on the property.

Even if you have recovered your cost or other basis of the property, you may take a deduction for percentage depletion.

If you can use percentage depletion and if it is less than cost depletion for any year, you must use cost depletion for that year.

Oil and Gas Wells

The use of percentage depletion for oil and gas is not allowed, except for certain domestic gas and oil production. The percentage depletion rate is 15% of the gross income from the qualifying production from oil and gas property.

Gross income from the property does not include any lease bonuses, advance royalties, or other amounts payable without regard to production from the property.

Fixed contract. Income from natural gas sold under a fixed contract, from a well located in the United States or its possessions, qualifies for percentage depletion at 22%. Independent producers and royalty owners (small producers) may use percentage depletion with certain limits.

Small producers. Independent producers and royalty owners (small producers) qualify for a 15% rate for a maximum daily average of 1,000 barrels (6,000 cubic feet of natural gas is the equivalent of a barrel of oil). This is the small-producer exemption.

Gross income from oil and gas property. Gross income from oil and gas property (including geothermal steam wells) is the amount you receive from the sale of the oil or gas in the immediate vicinity of the well (at the well-head). If you do not sell the oil or gas on the property, but manufacture or convert it into a refined product before sale, or transport it before sale, the gross income from the property is the "representative market or field price" (RMFP) of the oil or gas at the well-head as of the date of sale, before conversion or transportation.

If gas is sold after it is removed from the premises, for a price that is lower than the RMFP, gross income from the property for depletion is determined without regard to the RMFP.

Natural gas from geopressured brine. Qualified natural gas from geopressured brine is eligible for percentage depletion at the rate of 10%.

Partnership oil and gas properties. For partnership property the depletion allowance, whether by cost or percentage, must be figured separately by each partner and not by the partnership. This is so because only the partner will have the necessary information to determine the 65% limitation of taxable income as discussed earlier under *Percentage depletion.*

For the partner to compute cost depletion, the partnership must allocate to each partner that partner's share of the adjusted basis of each partnership oil or gas property that was acquired by the partnership.

Each partner, after receiving the information from the partnership, must keep this information separately. Thereafter, in those separate records, the partner must reduce the share of the adjusted basis of each property by the amount of depletion taken on the property each year by that partner, and use that reduced adjusted basis in the computation of any cost depletion or to figure any gain or loss if the partnership later disposes of the property.

Reporting the deduction. The oil and gas partner reports and deducts depletion in Part II of Schedule E (Form 1040), *Supplemental Income and Loss.*

In addition to completing Schedule E, the partner may also have to complete Schedule SE (Form 1040), *Social Security Self-Employment Tax,* if partnership net income is considered net earnings from self-employment. For more information, see Publication 533, *Self-Employment Tax.*

S corporation oil and gas properties. The depletion allowance is figured separately by each shareholder of an S corporation in the same way as by a partnership and its partners.

For an S corporation shareholder to compute cost depletion, the S corporation must allocate to each shareholder that shareholder's adjusted basis of each oil or gas property held by the S corporation.

Each shareholder must separately keep records of the shareholder's pro rata share of the adjusted basis in each oil and gas property of the S corporation. Thereafter, the shareholder must adjust the share of the adjusted basis for any depletion taken on the property by the shareholder, and use the adjusted basis each year to compute cost depletion or to compute the shareholder's gain or loss on the disposition of the property by the S corporation.

Natural and Geothermal Deposits

Mine and other natural deposits and geothermal deposits qualify for percentage depletion.

Mine and other natural deposits. The percentage of your gross income from a natural deposit that you may deduct as depletion is based upon the type of deposit being mined.

Some of the depletion percentages of the more common minerals follow:

Deposits	Percent
Sulphur and uranium; and, if from deposits in the United States, asbestos, lead, zinc, nickel, mica, and certain other ores and minerals	22
If from deposits in the United States, gold, silver, copper and iron ore, and oil shale	15
Coal, lignite, and sodium chloride	10
Clay and shale used in making sewer pipe or bricks or used as sintered or burned lightweight aggregates	7½
Clay (used or sold for use in manufacture of drainage and roofing tile, flower pots, and kindred products), gravel, sand, and stone	5
Most other minerals, including carbon dioxide produced from a well, and metallic ores	14

Reduction of percentage depletion for corporations. The percentage depletion deduction of a corporation for iron ore and coal (including lignite) is reduced by 20% of the excess of:

1) The amount of the percentage depletion deduction for the tax year, over

2) The adjusted basis of the property at the close of the tax year (determined without the depletion deduction for the tax year).

Gross income from mining. Gross income from a mining property is the gross income from extracting ores or minerals from the ground, treatment processes, and transporting them not more than 50 miles from the point of extraction to the plant or mill in which a recognized mining treatment process is applied.

Gross income from mining property also includes the separately stated excise tax received by a mine operator from the sale of coal which the mine operator must pay to finance black lung benefits.

Figuring depletion. To figure your depletion allowance for mineral properties, you figure it under both the cost and percentage depletion methods for each property, and claim a deduction for the greater of the two amounts.

Geothermal deposits. Geothermal deposits located in the United States or its possessions qualify for percentage depletion at the rate of 15%. A geothermal deposit is a geothermal reservoir of natural heat stored in rocks or in a watery liquid or vapor. It is not considered a gas well.

Gross income from the property does not include any lease bonuses, advance royalties, or other amounts payable without regard to production from the property.

Lessor's Gross Income

A lessor's gross income from the lease of gas, oil, or mineral property for percentage depletion usually is the total of the royalties received from the lease, excluding rentals that are not payment for units of mineral produced or to be produced.

Bonuses and advance royalties. These are payments that a lessee makes to a lessor as consideration for the lease or for minerals, gas, or oil that are to be extracted from leased property. Both types of payments are made in advance of production. If you are the lessor, your income from bonuses and advanced royalties may be subject to an allowance for depletion.

Timber

You may figure timber depletion only by the cost method. Percentage depletion does not apply to timber. Your depletion is based on your cost or other basis in the timber. Your cost does not include any part of the cost of the land.

Figuring the deduction. Because depletion takes place when standing timber is cut, you may figure your depletion deduction only after the timber is cut and the quantity is first accurately measured. At the end of your tax year include in your closing inventory of products cut from timber as a cost item any allowable depletion on the timber from which the unsold products are cut.

You figure your depletion allowance for your tax year by multiplying the number of timber units cut by your depletion unit. Your depletion unit is your cost or adjusted basis of the standing timber on hand divided by the total depletable units, (such as, thousand board-feet (MBF), cords, etc.).

Sale or exchange. You may elect, under certain circumstances, to treat the cutting of timber as a sale or exchange. See the discussion under *Timber* in Chapter 22.

Timber form. Form T, *Forest Industries Schedules,* must be attached to your income tax return if you claim a deduction for depletion of timber.

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14. Bad Debts

If someone owes you money and you cannot collect on the debt, you have a bad debt. You may generally deduct the amount that you are owed on a bad debt when you figure your income for tax purposes. For a bad debt to qualify for the deduction, there must be a true creditor-debtor relationship between you and the person or organization that owes you the money. There must be a legal obligation to pay you a fixed sum of money. You must realize a loss because of your inability to collect the money owed to you.

To take the bad debt deduction, you must show that the debt is worthless and will remain that way. You must have taken reasonable steps to collect the debt. However, it is not necessary to go to court if you can show that a judgment from the court would be uncollectible. (Bankruptcy is generally good evidence of the worthlessness of at least part of an unsecured and unpreferred debt.)

A bad debt may be either totally or partly worthless. If you will be able to collect part, but not all, of what you are owed, you have a partly worthless bad debt. If you will not be able to collect any of what you are owed, even if you collected some of the debt in the past, you have a totally worthless bad debt.

You may take a bad debt deduction only if you have an actual loss of money, or if you have already reported the amount you were to be paid as income.

Nonbusiness Bad Debts

There are two kinds of bad debts: business bad debts and nonbusiness bad debts. A business bad debt, generally is one that comes from operating your trade or business. All other bad debts are nonbusiness bad debts.

Example. An architect made personal loans to several friends who were not clients. She could not collect on some of these loans. They are deductible only as nonbusiness bad debts, since the architect was not in the business of lending money and the loans do not have any relationship to the architect's business.

Deductible nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless bad debt.

Loan or gift. If you lend money to a relative or friend with the understanding that it is to be repaid, but you later forgive the debt, it is considered a gift, and not a loan. You cannot take a bad debt deduction for a gift. There must be a creditor-debtor relationship between you and the person or organization that owes you the money.

Worthless securities. If you own securities and they become totally worthless, you may take a deduction for a loss, but not for a bad debt. See *Worthless securities* in Publication 550, *Investment Income and Expenses.*

Business Bad Debts

A business deducts its bad debts from gross income when figuring its taxable income. Unlike nonbusiness bad debts, business bad debts are not deducted as short-term capital losses.

To be deductible as a business bad debt, a debt must be closely related to the activity of your business. There must have been a dominant business reason for you to have entered into the transaction as the creditor.

The bad debts of a corporation are always considered business bad debts.

Example. John Smith, an advertising agent, made loans to certain clients to retain their business. His dominant reason for making these loans was for his business. One of these clients later went bankrupt and could not repay him. Since John's business was the dominant reason for making the loan, the debt was a business debt and he may take a business bad debt deduction.

Credit transactions. Business bad debts are mainly the result of credit sales to customers. They can also be loans to suppliers, clients, employees, or distributors. Goods and services that customers have not yet paid for are shown in your books as either accounts receivable or notes receivable.

If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt. Accounts or notes receivable valued at fair market value at the time of the transaction are deductible only at fair market value, even though that value may be less than face value.

You may take a bad debt deduction on your accounts and notes receivable only if you have included the amount you are owed in your gross income for the current or an earlier tax year. This applies to amounts you are owed from all sources of taxable income, such as sales, services, rents, and interest.

If you meet certain requirements, you can use the nonaccrual-experience method, discussed later. This method allows you to estimate uncollectible amounts. You do not include them in your gross income.

Accrual method taxpayers. Accrual method taxpayers normally report income that is due them as soon as it is earned. Therefore, they may take a bad debt deduction when they are unable to collect what is owed them, provided they have included that amount in income.

Cash method taxpayers. Cash method taxpayers normally do not report the income that is due them until they actually receive payment. Therefore, they may not take a bad debt deduction on payments they have not received or cannot collect.

Former business. You may deduct a business bad debt that becomes worthless, even if the debt became worthless after you went out of business.

For more information, see Chapter 12 in Publication 535, *Business Expenses.*

Loans or capital contributions. You are not allowed to take a bad debt deduction for loans you made to a corporation if the loans are actually capital contributions.

Insolvency of partner. If your business partnership breaks up and one of your former partners is unable to pay any of the partnership's debts, you may have to pay more than your share of the partnership's debts. When you pay any part of the insolvent partner's share of the debts, you can take a bad debt deduction.

Business loan guarantees. If you guarantee payment of another person's debt and then have to pay it off, you may be able to take a bad debt deduction for your loss. It does not matter in what capacity you make the guarantee, whether as guarantor, endorser, or indemnitor. To qualify for a bad debt deduction, a guarantee you enter into must either be entered into with a profit motive or it must be related to your trade or business, or to your employment.

Example. Bob Zayne, owns the Zayne Dress Company. He guaranteed payment of a $20,000 note for Elegant Fashions, a dress outlet. Elegant Fashions is one of Mr. Zayne's largest clients. Elegant Fashions later files for bankruptcy and defaults on the loan. Mr. Zayne makes full payment to the bank. He can take a business bad debt deduction, since his guarantee was closely related to his trade or business. He was motivated by the desire to retain one of his better clients and keep a sales outlet.

Business bad debt. You must be able to show that your reason for guaranteeing the debt was closely related to your trade or business. Any guarantees you make to protect or improve your job are considered closely related to your trade or business as an employee.

Nonbusiness bad debt. You must be able to show that your reason for making the guarantee was to protect your investment or that the guarantee transaction was entered into with a profit motive. If you make the guarantee as a favor to friends and do not receive any consideration in return, it is considered a gift and you may not take a nonbusiness bad debt deduction.

Example. Henry Lloyd, an officer and principal shareholder of the Spruce Corporation, guaranteed payment of a bank loan the corporation received. The corporation defaulted on the loan and Henry made full payment. Because he entered into the guarantee to protect his investment in the corporation, Henry is able to take a nonbusiness bad debt deduction.

For more information on business bad debts, see Publication 535.

Reporting a Bad Debt

If you take either a business or nonbusiness bad debt deduction, it must be fully explained on your tax return. Attach a statement to your return that contains:

1) A description of the debt, including the amount, and the date it became due,
2) The name of the debtor, and any business or family relationship between you and the debtor,
3) The efforts you made to collect the debt, and
4) Why you decided that the debt was worthless.

Nonbusiness bad debts. Nonbusiness bad debts are deducted as short-term capital losses on Schedule D (Form 1040), *Capital Gains and Losses.* There are limits on how capital losses may be deducted. For a discussion of these limits, see Chapter 22, *Gains and Losses: Capital or Ordinary.*

In Part I, line 2d of Schedule D, enter the name of the debtor, and "schedule attached," in column a, and the amount of the bad debt in column (f). Use a separate line for each bad debt.

Business bad debts. Use the following guide to find which form you should use to report your business bad debt deductions.

Individuals. If you have a bad debt from operating a trade or business, take the deduction on line 9, Part II of Schedule C (Form 1040). If you have a bad debt from operating a farm, take the deduction on line 34 of Schedule F (Form 1040).

Corporations. Corporations should deduct bad debts on line 15 of Form 1120, line 15 of Form 1120-A, or line 10 of Form 1120S.

Partnerships. Partnerships deduct their business bad debts on line 14 of Form 1065.

Methods of Treating Business Bad Debts

There are two ways of to treat uncollectible amounts: the specific charge-off method for bad debts and the nonaccrual-experience method. All taxpayers, except for certain financial institutions must use the specific charge-off method. However, you may use the nonaccrual-experience method if certain requirements, discussed later, are met.

Specific Charge-Off Method

Using the specific charge-off method, you deduct specific business bad debts that become either partly or totally worthless during the tax year.

Partly worthless debts. You may deduct specific bad debts that are partly uncollectible. But your deduction is limited to the amount you charge off on your books during the tax year. You do not have to annually charge off and deduct your partly worthless debts. Instead you may delay the charge-off until a later year. Also, you may wait until more of the debt has become worthless, or until you have collected all you can on the debt and it is totally worthless. You may not, however, deduct any part of the bad debt in a year after the year in which the debt becomes totally worthless.

Deduction disallowed. Usually, you may take a partial bad debt deduction only in the year you make the charge-off on your books. However, the Internal Revenue Service may not allow your deduction. If the debt then becomes partly worthless in a later tax year, you can deduct the amount you charge off in the later year, plus the amount charged off in the earlier year. The charge-off in the earlier year, unless reversed on your books, fulfills the charge-off requirement for the later year.

Totally worthless debts. A totally worthless bad debt is deducted only in the tax year it becomes totally worthless. The deduction for the debt must not include any amount deducted in an earlier tax year when the debt was only partly worthless.

You are not required to make an actual charge-off on your books to claim a bad debt deduction for a totally worthless debt. However, you may want to do so. If a debt you claim to be totally worthless is not charged off on your books and the IRS later rules that the debt is only partly worthless, you will not be allowed any deduction. A deduction of a partly worthless bad debt is limited to the amount actually charged off.

Recovery of a bad debt. If you deducted a bad debt and in a later tax year recover (collect) all or part of it, you may have to include the amount you recover in your gross income. However, you may exclude from gross income the amount recovered up to the amount of the deduction that did not reduce your tax in the year deducted.

See *Recoveries* in Publication 525, *Taxable and Nontaxable Income,* for more information on recovered amounts.

Example. In 1989, the Willow Corporation had gross income of $158,000, a bad debt deduction of $3,500, and other allowable deductions of $49,437. The corporation reported on the accrual method of accounting and used the specific charge-off method for bad debts. In 1990, the Willow Corporation recovers part of the $3,500 it had deducted in 1989. It must include the part recovered in income for 1990. The entire bad debt deduction reduced the tax on the 1989 corporate return. For 1990, Willow Corporation will report the recovery as "Other Income" on its corporate return.

Property received for a debt. If you receive property in partial settlement of a debt, you must reduce the debt by the fair market value of the property you received. Any amount of the unpaid debt remaining is deductible as a bad debt in the year the debt is determined to be worthless and is charged off.

If you later sell this property that you received, any gain you got (from the sale) is considered separately from your having received the property in partial settlement of a debt. Therefore, this gain is includible in your gross income. Any gain is not a recovery of a bad debt previously deducted without tax benefit. Instead, it is includible in gross income. For information on the sale of an asset, see Chapter 21, *Sales and Exchanges.*

Bankruptcy claim. You can only deduct the difference between the amount owed to you by a bankrupt entity and the amount you received from the distribution of its assets as a bad debt.

Net operating loss. A bad debt deduction may produce or add to a net operating loss. If you have a net operating loss one year, you may carry the loss back or forward to other tax years and deduct the loss from your income earned in those years. As a result, a bad debt deduction that contributes to a net operating loss helps lower taxes in the year to which the net operating loss is carried. See Chapter 20, *Net Income or Loss,* for information on operating losses.

Nonaccrual-Experience Accounting Method

If you use an accrual method of accounting and you qualify under certain rules, you may be able to use the nonaccrual-experience method of accounting for bad debts. Under this method, you do not have to accrue income that you do not expect to collect.

The nonaccrual-experience method applies only to amounts to be received (accounts receivable) for the performance of services. It may not be used if you require that interest or penalties be paid for late payments. If you determine that, based on your experience, your accounts receivable will not be collected, do not include it in gross income for the tax year.

Performing services. You may use the nonaccrual-experience method only for amounts you earned by performing services, and that you would otherwise have to include in income. The nonaccrual-experience method may not be used for amounts owed to you because you are engaged in activities such as lending money, selling goods, or acquiring receivables or other rights to receive payment from other persons.

Interest may not be charged on amounts due. Generally, the nonaccrual-experience method may not be used for amounts due for which interest or a late payment penalty is required. However, if you offer a discount for early payment of an amount due, you will not be regarded as charging interest or requiring a late payment penalty if:

1) The full amount due is otherwise accrued as gross income at the time you provide the services, and
2) You treat the discount for early payment as an adjustment to gross income in the year of payment, provided you receive payment within the time you allow the discount.

You may apply the nonaccrual-experience method under either a separate receivable system or a periodic system. Under the separate receivable system, apply the nonaccrual-experience method separately to each account receivable. Under the periodic system, you apply the nonaccrual-experience method separately to the total of the qualified accounts receivable at the end of your tax year.

Each system is also treated as a separate method of accounting. You generally may not change from one system to the other without the consent of the IRS.

Generally, you need the consent of the IRS to change to either system under the nonaccrual-experience method from a different method of accounting.

For more information on the separate receivable system, see section 1.448-2T of the income tax regulations. For more information on the periodic system, see Notice 88-51, 1988-1, CB 535.

15. Travel, Transportation, Entertainment, and Gift Expenses

Important Change for 1990

Standard mileage rate. The standard mileage rate for 1990 is 26 cents per mile for all business miles. You are not subject to the 15,000 mile annual limit which applied in prior years. See *Standard mileage rate.*

This chapter explains the conditions under which you may deduct business-related expenses for travel, transportation, meals, entertainment, and gifts on your federal income tax return. It also discusses the reporting and recordkeeping requirements to prove these expenses.

Travel Expenses

Travel expenses are your ordinary and necessary expenses while traveling away from home for your business or profession. You cannot deduct expenses that are for personal or vacation purposes or to the extent that they are lavish or extravagant.

Deductible travel expenses include:

1) Air, rail, and bus transportation,
2) Operating and maintaining your car,
3) Taxi fares or other costs of transportation between the airport or station and your hotel, from one customer to another, or from one place of business to another,
4) Transportation from the place where you eat and sleep to your temporary work assignment,
5) Baggage charges and transportation costs for sample and display material,
6) Meals and lodging (see *Meal and Entertainment Expenses,* later, for rules on deducting meal expenses),
7) Cleaning and laundry expenses,
8) Telephone and telegraph expenses,
9) Public stenographers' fees,
10) Operating and maintaining housetrailers,
11) Tips that are incidental to any of these expenses, and
12) Other similar ordinary and necessary expenses related to travel.

Travel expenses do not include expenses for entertainment. Travel expenses do not include expenses for transportation while not traveling away from home. These are discussed later.

Away from home. You are traveling away from home if your business activities require you to be away from the general area of your tax home (see *Tax home,* later) substantially longer than an ordinary day's work and, during your time off while away, you need to get sleep or rest to meet the demands of your work. This does not mean napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

Standard meal allowance. You can deduct a standard amount for your daily meals (instead of deducting the actual cost) while you are traveling away from home for business. The standard amount is considered adequately accounted for but you must keep records to prove the time, place, and business purpose of your travel. See *Records,* later.

The standard meal allowance is $26 per day for most areas. For certain high-cost areas, the allowance is $34 per day. The areas eligible for this higher allowance are listed in Publication 463, *Travel, Entertainment, and Gift Expenses.* Also, a special $30 rate may apply to transportation workers, as discussed later.

Using the standard meal allowance is considered an adequate accounting for the amount. Therefore, if under your accountable plan your employee also proves to you the time, place, and business purpose of the travel, do not include any reimbursement up to the standard meal allowance on the employee's Form W-2. Also, you, as the employer, will be subject to the 80% limit discussed under *Meal and Entertainment Expenses,* later.

Prorating the standard meal allowance. If you are not traveling for the entire 24-hour day, you may prorate the standard meal allowance by dividing the day into 6-hour quarters. The 6-hour quarters are: midnight to 6 a.m.; 6 a.m. to noon; noon to 6 p.m.; and 6 p.m. to midnight. You can claim one-fourth of the full day standard meal allowance for each 6-hour quarter of the day during any part of which you are either traveling or away from home.

Example. You live in Los Angeles and conduct your concrete business out of your home. You contract to do a job in San Francisco. You leave home at 8:00 a.m. on March 20. Your assignment is completed on March 23. You arrive home at 4 p.m. of that day. You are considered to be traveling for 3½ days (a ¾ day on March 20 + 2 full days + another ¾ day on March 23). Your standard meal allowance is $119 (3½ × $34) while on this assignment.

Related to employer. If you are related to your employer you must be prepared to prove your actual expenses to the IRS even if you used the standard meal allowance to account to your employer. You are related to your employer if you are related as defined in Chapter 4 under *Related persons,* except that the 50% stock ownership rule in item (5) of that discussion is 10% for this purpose.

Travel outside continental U.S. The $26 and $34 standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other locations outside the United States. The standard meal allowance for these areas is 40% of the total federal per diem rate (which includes lodging). These rates are published in the *Federal Travel Directory,* the *Federal Registry,* and can also be obtained from the U.S. Government Printing Office.

Special rate for transportation workers. You may be able to use a special standard meal allowance if you are in the transportation industry. You are in the transportation industry if your work:

1) Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and
2) Regularly requires travel away from home and, usually part of each trip is in an area eligible for the regular $26 allowance and part of each trip is in an area eligible for the $34 allowance.

If this applies to you, you can use a $30 a day standard meal allowance ($34 for travel outside the continental United States). If you choose to use this rate for any trip, you cannot use the regular standard meal allowance for any of your trips that year.

Investment-related travel. If you took a trip to attend a convention, seminar, or similar meeting, and the expenses were not ordinary and necessary expenses of carrying on your trade or business, you cannot deduct any portion of the cost of the trip. For example, you cannot deduct the cost of investment seminars or stockholders' meetings.

New business. You cannot deduct amounts you spend for travel to conduct a general search for, or preliminary investigation of, a new business. For more information, see *Going Into Business* in Chapter 5. If you move your home because you start a new business, you may qualify for a moving expense deduction. You must work full time on a self-employed basis for at least 78 weeks during the 24 months following the move, 39 weeks of which are in the first 12 months. Your new job location must be at least 35 miles farther from your former home than your old job location was. For information, see Publication 521, *Moving Expenses.*

Tax home. Generally, your tax home is the general area or entire city in which your business is located. The location of your family home does not matter. In some instances, you may be considered as traveling away from home even while working in the city in which you and your family live.

Example. You are a sales representative. Your family home is in Pittsburgh. You are required to spend 12 weeks a year at the headquarters of your supplier in Pittsburgh to get technical training and to become familiar with new products. Your sales territory is Maryland, and you conduct your sales activities out of your office in Baltimore. In Baltimore, you rent an apartment, but you eat most of your meals in restaurants. Your income is from sales commissions earned in the Baltimore area.

Because you spend most of your working time in Baltimore and earn most of your income from sales in Baltimore, that city is your tax home. You cannot deduct any expenses for meals and lodging you have there. However, when you return to your supplier's headquarters in Pittsburgh, you are away from your tax home even though you stay at your family home. Therefore, you can deduct the cost of your round trip between Baltimore and Pittsburgh, and your part of your family living expenses for meals (subject to the limit) and lodging while you are living and working in Pittsburgh.

Two offices. If you have two or more offices or businesses in separate areas, your tax home is the general area where your main place of business or main office is located.

You should use the following factors in determining your main place of business:

1) The total time you ordinarily spend working in each area,
2) The degree of your business activity in each area, and
3) The relative amount of your income from each area.

Travel in the United States

If your trip was entirely for business, you can deduct your ordinary and necessary travel expenses. If your trip was primarily personal, you cannot deduct any travel expenses, even if you had some business activity at your destination.

Primarily business. If your trip was primarily for business and, while at your business destination, you extended your stay for vacation, made a nonbusiness side trip, or had other nonbusiness activities, you can deduct the travel expenses to and from your business destination.

Example. You work in Atlanta and make a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend $450 for the 9 days you are away from home for travel, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days and your total cost would have been $400. You can deduct $400 (subject to the limit on meals) for your trip, including the round-trip transportation to and from New Orleans.

Primarily vacation. If your trip was primarily for vacation, the entire cost of the trip is a nondeductible personal expense, except for any expenses you have while at your destination that are directly allocable to your business.

A trip may be a vacation even if the promoter advertises that a trip to a resort or on a cruise ship is primarily for business. The scheduling of incidental business activities during a trip, such as viewing video tapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

Partially outside the United States. If part of your trip is outside the United States, the expenses for that part of the trip are deductible under the rules discussed in *Travel Outside the United States,* later. The expenses for the part of the trip in the United States are deductible under the rules discussed in this section. The United States includes the 50 states and the District of Columbia. Travel outside the United States does not include travel from one point in the United States to another point in the United States.

Public transportation. If you travel by public transportation, any place in the United States where the vehicle makes a scheduled stop is a point in the United States.

Example 1. You fly from New York to Puerto Rico, with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. The return trip is all outside the United States, as there are no scheduled stops between Puerto Rico and New York.

Example 2. You travel by train from New York to Montreal. The travel from New York to the last scheduled stop in the United States is travel in the United States.

Private car. Travel by private car in the United States is travel between points in the United States, even though you are on your way to a destination outside the United States.

Example. You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border to Denver is travel in the United States. You count the time only from when you cross the border until you recross the border on the return trip as travel outside the United States.

Private plane. If you travel by private plane, any trip, or part of a trip, for which both your takeoff and landing are in the United States is travel in the United States, even if part of your flight is over a foreign country.

Example. You fly nonstop from Seattle to Juneau. Although the flight passes over Canada, the trip is considered to be travel in the United States.

Convention expenses. You can deduct travel expenses for yourself, but not for your family, to attend a convention if you can show that your attendance benefits your trade or business. If the convention is for investment, political, social, or other purposes unrelated to your trade or business, you cannot deduct the expenses. Nonbusiness expenses, such as social or sightseeing expenses, are personal expenses and are not deductible. Your appointment or election as a delegate does not, in itself, entitle you to, or deprive you of, a deduction. See *Foreign conventions,* later.

The agenda of the convention need not deal specifically with your official duties or the responsibilities of your position or business. It is enough if the agenda is so related to your active trade or business and your responsibilities that attendance for a business purpose is indicated.

Expenses paid by others. You cannot deduct expenses paid by others or personal expenses you paid for your family members. You must reduce the expenses you pay by reimbursements or allowances received from others.

Expenses for your spouse. If your spouse goes with you on a business trip or to a business convention, you cannot deduct the part of the expenses for travel, meals, and lodging for your spouse, unless you can prove a real business purpose for your spouse's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.

Example. You drive to Chicago on business and take your spouse with you. No business purpose is served by your spouse's presence. You pay $115 a day for a double room. A single room costs $90 a day. You can deduct the total cost of driving your car to and from Chicago, but only $90 a day for your hotel room. If you use public transportation, you can only deduct your fare.

Travel Outside the United States

If you travel outside the United States and the entire time is spent on business activities, you can deduct your travel expenses as if the travel had been entirely in the United States. Travel outside the United States does not include travel from one point in the United States to another point in the United States. If part of your trip is in the United States, the expenses for that part of the trip are deductible under the rules discussed in *Travel in the United States,* earlier. The expenses for the part of the trip outside the United States are deductible under the rules discussed in this section.

Primarily business. If your travel was primarily for business, but there were some nonbusiness activities, you may not be able to deduct all of your travel costs, including meals and lodging, while going from your home to your business destination and back. You may have to divide the expenses between business and nonbusiness activities. See Publication 463, *Travel, Entertainment, and Gift Expenses.*

Primarily vacation. If your travel was primarily for vacation, or for investment purposes, and some time was spent attending brief professional seminars or a continuing education program, the entire cost of the trip is a nondeductible personal expense, except for registration fees and any other expenses incurred that were directly related to your business.

Foreign conventions. You cannot deduct expenses for attending a convention, seminar, or similar meeting held outside the North American area ***unless*** the meeting is directly related to your trade or business. Also, it must be as reasonable to hold the meeting outside the North American area as in it.

The North American area includes the United States, its possessions, Canada, Mexico, Jamaica, Barbados, Bermuda, Trinidad and Tobago, Dominica, the Dominican Republic, Micronesia, Grenada, and Palau. For foreign conventions, U.S. possessions include Puerto Rico, Guam, American Samoa, and the U.S. Virgin Islands. For more information, see Publication 463.

Transportation Expenses

Transportation expenses include the ordinary and necessary expenses of getting from one work place to another in the course of your business or profession when you are ***not*** traveling away from home. Expenses for transportation while traveling away from home are deductible as travel expenses.

Transportation expenses include the cost of travel by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car, but ***not*** the cost of meals and lodging. For information on how to deduct transportation expenses, see *How to Report,* later.

Commuting expenses. You cannot deduct the costs of taking a bus, trolley, subway, taxi, or driving a car between your home and your main or regular place of work. These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the trip.

Example. You had a telephone installed in your car. You sometimes use that telephone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work and you have a business discussion in the car. These activities ***do not change*** the trip from commuting to business. Your commuting expenses are not deductible.

Parking fees. Fees paid to park your car at your place of business are nondeductible commuting expenses.

Advertising display on car. The use of your car to display material that advertises your business does not change personal use to business use. If you use this car for commuting or other personal use, your expenses for such use are not deductible.

Car Expenses

If you use your car for business purposes, you may be able to deduct car expenses. The deductible items include the costs of:

Gas
Oil
Tolls
Tires
Garage rent
Lease fees
Rental fees
Parking fees
Repairs
Licenses
Insurance
Depreciation

Instead of figuring actual expenses, you may be able to use the standard mileage rate (discussed later).

Business and personal use. If you use your car for both business and personal purposes, you must divide your expenses between business and personal use. Also, see Publication 917 for special rules that may apply if you use your car 50% or less for business.

Example. You are a contractor and drive your car 20,000 miles during the year: 12,000 for business and 8,000 miles for personal use. You can claim only 60% (12,000 ÷ 20,000) of the cost of operating your car as a business expense.

Employee use of car. If your employees use their cars (or other vehicles) in their work for you, they cannot take a depreciation deduction unless this use is for your convenience as their employer and is required by you as a condition of employment.

The use of their cars must be required for the employees to perform their assigned duties properly. Whether this use is required depends on all the facts and circumstances.

Additionally, your employees must use their cars more than 50% for business to qualify for the section 179 deduction.

Limits. The date you place a car in service determines the maximum allowable depreciation. For a discussion on how to figure depreciation on your car, see Publication 917, *Business Use of a Car.* Publication 917 contains a full discussion of the section 179 and depreciation deductions for your car.

For information on figuring your basis, see Chapter 6. If you dispose of business property, see Chapters 22 and 23.

Leasing a car. If you lease a car that you use in your business you can deduct the part of each lease payment that is for the use of the car in your business. You cannot deduct any part of a lease payment that is for commuting to your regular job or other personal use of the car. You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a car even if the payments are called lease payments. (A lease with an option to buy may be a lease or a purchase contract, depending on the intent of the parties.) If you lease a car after June 18, 1984, you may have to include in income an amount called the "inclusion amount." For more information, see Publication 917.

Standard mileage rate. Instead of figuring actual expenses, you can use the standard mileage rate of 26 cents a mile for an unlimited number of business miles. Beginning in 1990, the 15,000 mile annual limit no longer applies. You can use this rate instead of your actual expenses (including depreciation), in figuring the deductible costs of operating a passenger car, including a van, pickup, or panel truck. You can use the standard mileage rate whether or not you are reimbursed and whether or not any reimbursement is more or less than the amount figured using the standard mileage rate.

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car in any year, you must choose to use it in the first year you place the car in service in your business. In later years, you can use the standard mileage rate or actual expenses. If you do not choose the standard mileage rate in the first year, you cannot use it for that car in any year.

If you use the standard mileage rate in the first year of business use, you are considered to have made an election not to use the accelerated cost recovery system (ACRS) discussed in Publication 534, *Depreciation,* or the modified accelerated cost recovery system (MACRS), discussed in Chapter 12. You also cannot claim the section 179 deduction. If you change to the actual cost method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation.

To use the standard mileage rate you must:

1) Own the car,
2) Not use the car for hire, for example, as a taxi, and
3) Not operate a fleet of cars using two or more at the same time.

Parking fees and tolls. In addition to the standard mileage rate, deduct any parking fees and tolls you have during business use.

Interest and state and local taxes. If you itemize your deductions on Schedule A, you can deduct part of the interest on car loans and state and local personal property taxes on motor vehicles even if you use the standard mileage rate. You cannot deduct sales tax.

Travel and Transportation of Your Employees

You can deduct the amount you reimburse your employees. However, if your employees account to you for meals and entertainment, you are subject to the 80% limit discussed under *Meal and Entertainment Expenses,* later.

Accountable plans. To be an accountable plan, your reimbursement or allowance arrangement must require your employees to:

1) Adequately account to you for their expenses, and
2) Return any excess reimbursement or allowance.

An "excess reimbursement or allowance" is any amount which the employee does not adequately account for as an ordinary and necessary business expense.

If you have an accountable plan and your employee adequately accounts to you for all of his or her expenses within a reasonable period of time and returns any excess within a reasonable period of time, do not include any of the reimbursements you pay in that employee's income on Form W–2.

Nonaccountable plans. You must treat as wages for employment tax purposes, any reimbursement or other allowance you pay an employee under a nonaccountable plan. These are arrangements which either:

1) Do not require your employees to adequately account to you for their expenses, or
2) Allow your employees to keep any excess reimbursement or allowance over the expenses for which they adequately accounted.

Payments from an otherwise accountable plan are treated as coming from a nonaccountable plan in the case of any employee who does not actually return all funds not adequately accounted for, even if the plan states that he or she must do so.

If your arrangement is a nonaccountable plan, your employees can deduct their expenses only as itemized deductions and the expenses will be subject to the 2% of adjusted gross income limit.

Adequate accounting by your employees. Your employees adequately account to you by giving you documentary evidence and an account book, diary, or similar record in which they entered each expense at or near the time they had it.

Your employees must account for ***all*** amounts received from you during the year as advances, reimbursements, or allowances for travel, transportation, entertainment, gifts, or any other expenses. These include amounts they charged to you by credit card or otherwise. Your employees must give you the same type of records and supporting information that they or you would be required to give to the IRS if it questioned a deduction on a tax return. Your employees must pay back any reimbursements or other expense allowances for which they do not adequately account or that exceeds the amount for which they accounted.

Keeping records. If you require that your employees account to you and return any excess allowances or reimbursements (and the employees meet these requirements), you must keep the records and supporting documents given to you by your employees to prove the deductions on your return for the allowances and reimbursements you paid them. Do not include these amounts in either box 10 or 12 on your employees' Forms W–2, *Wage and Tax Statement.*

If you do not require your employees to account to you or if you allow them to keep any excess allowances or reimbursements, you must include the entire amount you paid them as a reimbursement in the amount shown in box 10 on Form W–2. Also, you must include this amount as social security wages in box 12 if the total is no more than $51,300. If an employee does not follow the rules of your accountable plan, you must treat the amounts you pay that employee as if they came from a nonaccountable plan.

Per diem allowance or reimbursement. You may be able to prove the amount of an expense by using a per diem allowance amount. If you reimburse your employees for their lodging, meal, and incidental expenses at a fixed amount per day of business travel, that amount is called a per diem allowance. A per diem allowance satisfies the adequate accounting requirements if:

1) You reasonably limit payments of the travel expenses to those that are ordinary and necessary in the conduct of your trade or business,
2) The allowance is similar in form to and not more than the federal per diem (that is, the reimbursement varies based on how long the employee was traveling),
3) You are not related to the employee, and
4) The time, place, and business purpose of the travel are proved, as explained later under *Records.*

If the Internal Revenue Service finds that your travel allowance practices are not based on reasonably accurate estimates of travel costs, including recognition of cost differences in different areas, your employees will not have accounted to you and may each be required to prove their expenses to the IRS.

These rules also apply if you reimburse your employees only for their meal expense or pay them a separate per diem allowance for meals and incidental expenses that is not more than the standard meal allowance, discussed earlier. A per diem allowance is paid separately for meals and incidental expenses if you furnish lodging in kind, pay your employees a meal allowance plus the actual cost of their lodging, pay the hotel, motel, etc. directly for their lodging, or if you do not have a reasonable belief that your employees incurred lodging expenses, such as when they stay with friends or relatives or sleep in the cab of their truck.

Proving expenses with a per diem allowance. The amount of expense that can be proved this way cannot be more than the regular federal per diem rate or the High–Low method.

The regular federal per diem rate is the highest amount which the federal government will

Reporting Employee Travel, Transportation, Meal and Entertainment Expenses and Reimbursements

Type of Reimbursement or Other Expense Allowance Arrangement	Employer Reports on Form W-2	Employee Shows on Form 2106	Employee Claims on Schedule A
Accountable Adequate accounting and excess returned	Not reported	Not shown	Not claimed
Adequate accounting and return of excess both required but excess not returned	Excess reported as wages in Box 10 and, if applicable, in Box 12. Amount adequately accounted for is reported only in Box 17—it is *not* reported in Box 10 or in Box 12.	All expenses, and reimbursements reported on Form W-2, Box 17, *only* if some or all of the unreturned excess expenses are claimed.[1] Otherwise, form is not filed.	Expenses the employee can prove and which exceed the reimbursements received and reported on Form W-2, Box 17.[2]
Per diem or mileage allowance (up to government rate) Adequate accounting and excess returned	Not reported	All expenses and reimbursements *only* if excess expenses are claimed.[1] Otherwise, form is not filed.	Expenses the employee can prove and which exceed the reimbursements received.[2]
Per diem or mileage allowance (exceeds government rate) Adequate accounting up to the government rate only and excess not returned	Excess reported as wages in Box 10 and, if applicable, in Box 12. Amount up to the government rate is reported only in Box 17—it is *not* reported in Box 10 or in Box 12.	All expenses, and reimbursements equal to the government rate *only* if expenses in excess of the government rate are claimed.[1] Otherwise, form is not filed.	Expenses the employee can prove and which exceed the government rate.[2]
Nonaccountable Either adequate accounting or return of excess, or both, not required	Entire amount is reported as wages in Box 10 and, if applicable, in Box 12.	All expenses[1]	Expenses the employee can prove.[2]
No reimbursement	Normal reporting of wages, etc.	All expenses[1]	Expenses the employee can prove.[2]

[1] Any allowable expense is carried to line 20 of Schedule A and deducted as a miscellaneous itemized deduction.

[2] These amounts are subject to the applicable limits including the 80% limit on meals and entertainment expenses and the 2% of adjusted gross income limit on the total miscellaneous itemized deductions.

pay to its employees for lodging, meal, and incidental expenses (or for meal and incidental expense only) while they are traveling (away from home) in a particular area. The rates are different for different locations. You must use the rate in effect for the area where your employee stops for sleep or rest. Publication 1542, *Per Diem Rates*, shows the rates for the continental United States. See *Travel outside continental U.S.* under *Travel Expenses*, earlier, for some sources you can use to get other rates.

The High–Low method is a simplified method of computing the federal per diem rate and can be used for travel within the continental United States. This method avoids the need to keep a current list of the rate in effect for each city in the continental United States. The High–Low method specifies a limited number of locations where the per diem amount is considered to be $122. All other areas are treated as having an $85 per diem amount. The areas eligible for the $122 per diem amount under the High–Low method are shown in the chart *Locations Eligible for $122 Per Diem Amount* in Publication 463.

Car or mileage allowance. The rules governing car or mileage allowances you pay your employees are similar to those governing per diem allowances. You can pay a car or mileage allowance at the standard mileage rate (discussed earlier), at another rate per mile, or base the payment on a fixed and variable rate allowance (as described later).

Generally, the amount considered proven by your use of a car or mileage allowance cannot exceed the standard mileage rate. Your employees must prove to you the date, place, and business purpose for having the mileage expense.

Fixed and variable rate allowance (FAVR). You can choose to reimburse your employees for their car expenses by paying them a cents-per-mile rate to cover their operating costs (such as gas, oil, etc.) plus a flat amount to cover their fixed costs (such as depreciation, insurance, etc.). This is called a FAVR allowance. The amount of a FAVR allowance must be based on data that:

1) Is derived from the base locality or area in which the employee usually incurs the expense,
2) Reflects retail prices paid by consumers, and
3) Is reasonable and statistically defensible in approximating the actual expenses of employees receiving the allowance.

Special limitations and recordkeeping and reporting requirements apply to FAVR allowances. For example, at least 10 of your employees must be covered by such a FAVR allowance, the majority of the covered employees cannot be management employees, and each employee who receives the allowance must substantiate to you that he or she has business mileage at a rate of at least 5,000 miles per year. For more details, see Revenue Procedure 90–34.

Withholding on advances. If you have an accountable plan, you do not have to withhold income tax on advances or reimbursements you make to an employee for necessary travel and other expenses incurred by the employee in connection with your business. However, withholding of employment taxes applies to any amount for which the employee does not adequately account within a reasonable period of time and any amount in excess of the amount of expenses that were timely substantiated if the employee fails to return the excess within a reasonable period of time. The IRS will consider accounting within 60 days of the advance to be reasonable. The IRS will consider amounts returned within 120 days after an expense is paid or incurred as returned within a reasonable period of time. When making a payment to an employee, either keep the reimbursements and wages separate or specifically identify how much of the payment is for wages and how much is for reimbursement.

Nondeductible meals. Payments you make to an employee for nondeductible meals an employee has on trips that do not require a stop for sleep or rest are compensation. You must report these payments on Form W–2 if these payments plus the employee's wages total $600 or more in a calendar year. You may report these payments on a separate Form W–2. You do not have to withhold income tax from these meal payments.

Reporting on Form W–2. See the chart *Reporting Employee Travel, Transportation, Meal and Entertainment Expenses and Reimbursements*, earlier, for rules on how to complete your employees' Forms W–2.

Meal and Entertainment Expenses

Business meal and entertainment expenses are deductible only if they are ordinary and necessary expenses of carrying on your trade or business and can be proved by using the rules discussed later under *How to Report*, and *Records*. Unless certain exceptions apply, you must be able to show that they are:

1) ***Directly related*** to the active conduct of your trade or business, or
2) ***Associated*** with the active conduct of your trade or business. In this case the meal or entertainment must directly precede or follow a substantial business discussion.

Included. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. This includes entertaining guests at night clubs; social, athletic, and sporting clubs; theaters; sporting events; on yachts; or on hunting, fishing, vacation, and similar trips.

Entertainment also may include satisfying personal, living, or family needs of individuals, such as providing food, a hotel suite, or a car to business customers or their families.

Not included. Entertainment does not include supper money you give your employees, a hotel room you keep for your employees while on business travel, or a car used in your business (even if it is used for routine personal purposes, such as commuting to and from work). However, if you provide the use of a hotel suite or a car to your employee who is on vacation, this is entertainment of the employee.

Reciprocal meals and entertaining. Expenses are ***not*** deductible when business acquaintances take turns picking up each other's meal or entertainment checks without regard to whether any business purposes are served.

Entertainment tickets. In general, when figuring the deduction for the cost of a ticket, do not take into account more than the face value of the ticket. For example, you generally cannot deduct amounts in excess of face value that you pay to scalpers, ticket agencies, and ticket brokers.

80% Limitation

In general, you can deduct only 80% of your business-related meal and entertainment expenses. This limitation applies to employees or their employers, and to self-employed persons (independent contractors) or their clients, depending on whether the expenses are reimbursed.

The 80% limit applies to meals or entertainment expenses incurred while:

1) Traveling away from home (whether eating alone or with others) on business,
2) Entertaining business customers at your place of business, a restaurant, or other location, or
3) Attending a business convention or reception, business meeting, or business luncheon at a club.

The limit may apply to meals you furnish on your premises to your employees, even if the value of the meals is excluded from the employees' income. There are exceptions, discussed in Publication 463, to the 80% limit.

Taxes and tips relating to a meal or entertainment activity are included in the amount that is subject to the 80% limit. Expenses such as cover charges for admission to a night club, rent paid for a room in which you hold a dinner or cocktail party, or the amount paid for parking at a sports arena, are subject to the 80% limit. However, the cost of transportation to and from a business meal or entertainment activity that is otherwise allowable is not subject to the 80% limit.

If you pay or incur an expense for goods and services consisting of meals, entertainment, and other services (such as lodging or transportation), you must make an allocation, on a reasonable basis, between the expenses for meals and entertainment and the expenses for the other services. For example, you must make an allocation if a hotel includes one or more meals in its room charge, or you are provided with one per diem amount to cover both your lodging and meal expenses.

Application of the 80% limit. The 80% limit on meal and entertainment expense applies if the expense is otherwise deductible and is not covered by one of the exceptions discussed in Publication 463. The limit does not apply only to trade or business expenses. It applies to expenses incurred for the production of income including rental or royalty income. It also applies to deductible moving and educational expenses.

You apply the 80% limit after determining the amount that would otherwise qualify for a deduction. You first have to determine the amount of meal and entertainment expenses that would be deductible under the rules discussed earlier (and in Publication 463). You then apply the 80% limit.

Example 1. You spend $100 for a business-related meal. If $40 of that amount is not allowable because it is considered lavish and extravagant, the remaining $60 is subject to the 80% limit. Your deduction cannot be more than $48 (80% of $60).

Example 2. You purchase two tickets to a concert and give them to a client. You purchased the tickets through a ticket agent. You paid $150 for the two tickets, which had a face value of $60 each. Your deduction cannot be more than $96 (80% of the face value of the tickets).

For more information on meal and entertainment expenses, see Publication 463.

Business Gift Expenses

You can deduct the cost of business gifts. However, you cannot deduct more than $25 for business gifts you give, directly or indirectly, to any one individual during your tax year. If a gift to a company is not intended for the eventual personal use or benefit of a particular person or a limited class of people, it will not be considered an indirect gift to an individual.

A gift to the spouse of a person with whom you are doing business is an indirect gift to that person. However, if the spouse you give the gift to has an independent bona fide business connection with you, the gift generally will not be considered an indirect gift to the other spouse, unless it is intended for that spouse's eventual use or benefit. These rules also apply to gifts to any other family member.

If you and your spouse both give gifts, both of you are treated as one taxpayer, even if you have separate businesses or are separately employed and even if each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Exceptions. The following are not considered gifts subject to the $25 limit.

1) An item that costs $4 or less, on which your name is clearly and permanently imprinted, and which is one of a number of identical items you widely distribute. This includes items such as pens, desk sets, and plastic bags and cases.
2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the $25 rule.

A related cost is considered incidental only if it does not add substantial value to the gift. For example, the cost of gift wrapping is considered an incidental cost, but the purchase of an ornamental basket for packaging fruit is not considered an incidental cost of packaging if the basket has a value that is substantial in relation to the value of the fruit.

Employee achievement awards. Employee achievement awards are not treated as gifts. For information on how to deduct the cost of these awards, see Publication 535, *Business Expenses*.

Gift or entertainment. Any item that might be considered either a gift or entertainment generally will be considered entertainment. However, if you give a customer packaged food or beverages intended to be used at a later date, it is a gift.

If you provide tickets to a theater performance or sporting event for a business customer and do not go with the customer to the performance or event, you can treat the tickets as either a gift or entertainment, whichever is to your advantage. You can change your treatment of the tickets at a later date, but not after the time prescribed for the assessment of income tax. In most instances this is the 3 years after the due date of your income tax return. If you go with the customer to the event, you have no choice; the cost of the tickets is entertainment.

How to Report

The following discussions explain how to report your allowable expenses for travel, transportation, meals, entertainment, and gifts.

Independent contractor. If you have reimbursed travel, transportation, meal, entertainment, or gift expenses that you incurred on behalf of a client, you should provide an adequate accounting of these expenses to your client. If you do not account to your client for these expenses, you must include any reimbursements or allowances in income. You must keep adequate records of these expenses regardless of whether you account to your client for such expenses.

If you do not separately account for and seek reimbursement for meals and entertainment in connection with providing services for a client, you are subject to the 80% limit on such expenses. See *80% Limitation*, earlier.

Report travel and entertainment expenses on line 24 of Part II, Schedule C (Form 1040).

Client or customer. If you are a client or customer, you are not required to keep records to prove the reimbursements or allowances you give, in the course of your business, to an independent contractor for travel or gift expenses incurred on your behalf. However, you must keep records if:

1) You reimburse the contractor for meal or entertainment expenses incurred on your behalf, ***and***
2) The contractor adequately accounts to you for these expenses.

Contractor accounting. If the contractor does adequately account to you for meal and entertainment expenses, you must keep records documenting each element of the expense, as explained later under *Records*. Use your records as proof for a deduction on your tax return. If meals and entertainment are accounted for separately, you are subject to the limit discussed under *Meal and Entertainment Expenses*, earlier. You do not, however, have to file an information return to report amounts for which you reimbursed the contractor, as long as he or she adequately accounted to you for these expenses.

No contractor accounting. If the contractor does not adequately account to you for allowances or reimbursements of meal and entertainment expenses, then you do not have to keep your own separate records of these items incurred by the contractor on your behalf. You are not subject to the limit on meals and entertainment in this case. You can deduct the amounts if they are ordinary and necessary business expenses. However, you must file an information return (Form 1099–MISC) to report amounts paid to the independent contractor if the total of the reimbursements and any other fees is $600 or more during the tax year.

Records

You must be able to prove your deductions for travel, transportation, meal, entertainment, and business gift expenses by adequate records or by sufficient evidence that will support your own statement. Estimates or approximations do not qualify as proof of an expense.

Proving expenses. You can deduct expenses for transportation, travel, including meals, lodging, and related items while away from home, or expenses for a type of activity generally considered entertainment, amusement, or recreation, or expenses for a facility used in connection with such activity, or expenses for gifts, only if you can prove certain items.

Deductions are not allowed for approximations or estimates, or to the extent that the expense is lavish or extravagant. A receipt is ordinarily the best evidence to prove the amount of an expense.

Chart showing proof required. The chart shown later summarizes the factors in proving the elements of your expenses for travel, transportation, meals, entertainment, and gifts.

To deduct these expenses, you must be able to prove the items listed in Column 1 of the chart. You prove these items by having the information and receipts (where required) for the expenses listed in Column 2, 3, 4, or 5, whichever is applicable.

Adequate records. You should keep the proof you need for these items in an account book, diary, statement of expense, or similar record, supported by adequate documentary evidence (such as receipts, canceled checks, or bills), that together will support each element of an expense. Written evidence has considerably more value than oral evidence alone.

Duplicate information. You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner.

Timely recordkeeping. You do not need to write down the elements of every expense at the time of the expense. However, a record of the elements of an expense or of a business use made at or near the time of the expense or use, supported by sufficient documentary evidence, has more value than a statement prepared later when generally there is a lack of accurate recall. A log maintained on a weekly basis, which accounts for use during the week, is considered a record made at or near the time of the expense or use.

Clubs. You cannot deduct any part of the dues and fees you pay a club unless you can prove you use the club more than 50% for entertaining, including meals, to further your business. To show this, your records must prove all the elements of an expense for each use of the club you claim to be for your business.

Each time you use the club for nonbusiness purposes, include in your records the cost, date, number of people, and the nature of the entertainment. A notation, such as "personal use" or "family use," is enough to describe the nature of the nonbusiness use.

If your records are not adequate, your use of the club will be considered primarily personal. You will not be allowed a business deduction.

Separating expenses. Each separate payment is usually considered a separate expense. If you entertain a customer or client at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are separate expenses. You must record them separately in your records.

Totals permitted. Some items may be totaled in reasonable categories. You may make one daily entry for categories such as taxi fares, telephone calls, gas and oil, and other incidental travel costs. Meals should be in a separate category. You should include tips with the costs of the services you received.

Expenses of a similar nature occurring during the course of a single event are considered a single expense. For example, if during entertainment at a cocktail lounge, you pay separately for each serving of refreshments, the total expense for the refreshments is treated as a single expense.

Documents required. Documentary evidence is required to support all lodging expenses (however, see *Per diem allowance or reimbursement*, earlier) while traveling away from home. It is also required for any other expense of $25 or more, except that if evidence is not readily available for transportation charges, it is not required.

Adequate evidence. Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense. For example, a hotel receipt is enough to support expenses for business travel if it has the name and location of the hotel, the dates you stayed there, and separate amounts for charges such as lodging, meals, and telephone. A restaurant receipt is enough to prove an expense for a business meal if it has the name and location of the restaurant, the number of people served, and the date and amount of the expense. If a charge is made for items other than meals and beverages, the receipt must show that this is the case.

Canceled check. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check does not prove a business expense without other evidence to show that it was for a business purpose.

Business purpose. A written statement of the business purpose of an expense is generally required. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, a written explanation is not required.

Example. A sales representative who calls on customers on an established sales route ordinarily does not have to submit a written explanation of the business purpose for traveling that route.

Business relationship. If you entertain a large number of people, you do not have to record each name of a readily identifiable group of people. It is enough to designate the class. For example, if you entertain all stockholders of a small corporation, an entry such as "all stockholders of the Acme Corporation" is enough. However, if the identity of the class is not enough to identify the persons entertained, then each person must be listed.

Gift recipient's name. The name of the recipient of a business gift does not always have to be recorded. A general listing will be enough if it is evident that you are not trying to avoid the $25 annual limit on the amount you can deduct for gifts to any one person. For example, if you buy a large number of tickets to local high school basketball games and give one or two tickets to each of a number of customers, it is usually enough to record a general description of the recipients.

Confidential information. Confidential information relating to an element of a deductible expense, such as the place, business purpose, or business relationship, need not be put in your account book, diary, or other record. However, the information has to be recorded elsewhere at or near the time of the expense and be available to fully prove that element of the expense.

Incomplete records. If you prove the total cost of travel or entertainment but you cannot prove how much it cost for each person, you must divide the cost among your guests if a determination is necessary.

If you do not have adequate records to prove an element of an expense, then you must prove the element by:

1) Your own statement, whether written or oral, containing specific information in detail as to the element, and
2) Other supporting evidence sufficient to establish the element.

Additional information. The IRS may require additional information to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

Keeping records. It is the responsibility of the employer to keep the records and supporting documentary evidence submitted by employees to prove the deductions on the employer's return for the allowances and reimbursements paid to employees.

Generally, you should keep records for 3 years from the date the return was due or filed, or 2 years from the date the tax was paid, whichever date is later.

Elements to be proved (1)	Travel Expenses (2)	Meal and Entertainment Expenses (3)	Gift Expenses (4)	Transportation (car) Expenses (5)
Amount	Amount of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories, such as taxis, daily meals for traveler, etc.	Amount of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Cost of gift.	1) Amount of each separate expense including cost of the car, 2) Mileage for each business use of the car, and 3) Total miles for the tax year.
Time	Date you left and returned for each trip, and number of days for business.	Date of meal or entertainment or use of a facility for entertainment. For meals or entertainment directly before or after a business discussion, the date and duration of the business discussion.	Date of gift.	Date of the expense or use.
Place	Name of city or other designation.	Name and address or designation of place of meal or entertainment, or place of use of a facility for entertainment. Type of entertainment if not otherwise apparent. Place where business discussion was held if meal or entertainment is directly before or after a business discussion.	Not applicable.	Name of city or other designation if applicable.
Description	Not applicable.	Not applicable.	Description of gift.	Not applicable.
Business purpose	Business reason for travel or the business benefit gained or expected to be gained.	Business reason or the business benefit gained or expected to be gained. Nature of business discussion or activity.	Business reason for giving the gift or the business benefit gained or expected to be gained.	Business reason for the expense or use of the car.
Business relationship	Not applicable.	Occupations or other information—such as names or other designations—about persons entertained that shows their business relationship to you. If all people entertained did not take part in business discussion, identify those who did. You must also prove that you or your employee were present at the meal.	Occupation or other information—such as name or other designation—about recipient that shows his or her business relationship to you.	Not applicable.

16. Interest Expense

Interest is the amount you pay for the use of borrowed money. You may generally deduct all interest you pay or accrue in the tax year on a debt that is related to your trade or business. (However, see *Interest Capitalization*, discussed later.) Also, special rules apply if you have a loan on which the interest rate is less than the applicable federal rate. See *Below-Market Interest Rate Loans*, later.

To deduct the interest paid, you must be liable for its payment. For example, you may not deduct interest paid on a corporation's debt on your individual return.

Allocation of Interest

The rules for deducting interest vary, depending on whether it is used for business, personal, home mortgage, investment, or passive activities. If you use the proceeds of a loan for more than one expense, you must make an allocation to determine the amount of interest for each use of the loan's proceeds. (However, interest that is fully deductible home mortgage interest is not subject to these rules. See Publication 545.)

The most advantageous way for you to allocate interest is for you to keep the proceeds of a particular loan separate from any other funds. If you deposit the proceeds in an account containing other funds, or receive them in cash, you should generally use them for a specific purpose within 15 days if you do not want to allocate interest.

In general, you allocate the interest on a loan in the same way as the loan itself is allocated. This is true even if the funds are paid directly to a third party. You allocate loans by tracing disbursements to specific uses. If you must allocate your interest expense, use the following categories:

Expenditure	For More Information
Trade or business	See this chapter
Passive activity	Publication 925
Investment (including Portfolio)	Publication 550
Personal	Publication 545

Allocation based on the use of the loan's proceeds. A loan is allocated according to the use of its proceeds. You allocate interest on a loan in the same way as the loan is allocated for the same period. Loan proceeds and the related interest are allocated only by reference to the use of the proceeds. The allocation is not affected by the use of property that secures the loan.

Example. You use property that you use in your trade or business as security for a loan. You use the loan proceeds to buy an automobile for personal use. You must allocate interest expense on the loan to the personal expenditure (purchase of the automobile) even though the loan is secured by business property.

Allocation period. Allocate a loan to a particular use from the date the proceeds are used to the earlier of the date the loan is repaid or the date the loan is reallocated to another use.

Loan repayments. If, at the time you repay any part of a loan, the loan is allocated to more than one use, you are treated as repaying the loan in the following order:

1) Amounts allocated to personal use,
2) Amounts allocated to investments and passive activities (other than those included in (3) below),
3) Amounts allocated to passive activities in connection with a rental real estate activity in which you actively participate,
4) Amounts allocated to former passive activities, and
5) Amounts allocated to trade or business use and to expenses for certain low-income housing projects.

Partnerships and S corporations. Special rules apply to the allocation of interest expense in connection with debt-financed acquisitions of, and distributions from, partnerships and S corporations. These rules will not apply if the partnership or S corporation is formed or used for the principal purpose of avoiding the interest allocation rules.

Debt-financed acquisitions. This is the use of loan proceeds to purchase an interest in an entity or to make a contribution to the capital of the entity. If you purchase an interest in an entity, you allocate the loan proceeds and the interest expense among all the assets of the entity. The allocation can be based on the fair market value, book value, or adjusted basis of the assets, reduced by any debts allocated to the assets.

If you contribute to the capital of an entity, make the allocation based on the assets or by tracing the loan proceeds to the entity's expenditures. A purchase of an interest in an entity is treated as a contribution to capital to the extent the entity receives any proceeds of the purchases.

Example. You purchase an interest in a partnership for $20,000 using borrowed funds. The partnership's only assets include machinery used in its business valued at $60,000, and stocks valued at $15,000. You allocate the loan proceeds based on the value of the assets. Therefore, $16,000 of the loan proceeds ($60,000 / $75,000 X $20,000) and the interest expense on that part are allocated to trade or business use. $4,000 ($15,000 / $75,000 X $20,000) and the interest on that part are allocated to investment use.

Debt-financed distributions. Generally, if the entity borrows funds the general allocation rules discussed earlier in this section apply. If those funds are allocated to distributions made to partners and shareholders, the distributed loan proceeds and related interest expense must be reported to the partners and shareholders separately. This is because the loan proceeds and the interest expense must be allocated depending on how the partner or shareholder uses the proceeds. For example, if a shareholder uses distributed loan proceeds to invest in a passive activity, that shareholder's portion of the entity's interest expense on the loan proceeds is allocated to a passive activity use.

For more information on interest allocation, see Publication 545, *Interest Expense*.

Interest You May Deduct

Generally, the amount agreed upon by the lender and the borrower as interest may be deducted when paid or accrued, unless required to be capitalized. Both parties must intend that the loan will be repaid.

Insurance contracts. If you borrow on your life insurance, endowment, or annuity contract and use the proceeds for business purposes, you can take a business interest deduction. (However, you can not deduct the interest if you are required to capitalize it.) But, if you use the proceeds for a nonbusiness purpose, you can deduct the interest only as an itemized deduction on Schedule A (Form 1040). For more information, see Publication 545.

For loans under life insurance policies purchased after June 20, 1986, no interest deduction is allowed to the extent that total loans on policies covering an officer, employee, or individual financially interested in your trade or business is more than $50,000.

Mortgages. Monthly mortgage payments are usually made up of principal and interest. You can deduct only the interest, unless you are required to capitalize it. If you paid mortgage interest of $600 or more during the year on any one mortgage to a mortgage holder (including a financial institution, a governmental unit, or a cooperative housing corporation) in the course of that holder's trade or business, you will receive a Form 1098, *Mortgage Interest Statement*, or a similar statement.

Prepayment penalty. If you pay off your mortgage early and pay the lender a penalty for doing this, you can deduct the penalty as interest.

Points. The term "points" is often used to describe some of the charges paid by a borrower when the borrower takes out a loan or a mortgage. These charges are also called ***loan origination fees***, maximum loan charges, or premium charges. If any of these charges is solely for the use of money, it is interest.

These points are interest paid in advance and you may not deduct it all in one tax year. Instead, you may deduct some of this interest in each tax year during the period of the loan, unless it is required to be capitalized.

To figure how much to deduct in each tax year, divide the part of the loan period falling within your tax year by the total loan period. Then multiply this answer by the amount of prepaid interest. For example, if you take out a 10–year loan on October 2, 1990, so that only 3 months of the loan period fall in your 1990 tax year, in 1990 you could deduct only 3/120 of the payments that you made for the points. In 1991, you will be allowed to deduct 12/120 of the prepaid interest.

Expenses paid to obtain a mortgage. Certain expenses you pay to obtain a mortgage cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. However, they are not capital expenses that you add to the basis of your property. If the property mortgaged is business or income-producing property, you can amortize these costs over the life of the mortgage.

To figure your amortization deduction for a tax year, divide the part of the loan period that falls in your tax year by the total loan period. Then multiply the answer by the total amount of the expenses you paid to obtain the mortgage.

Partial liability. If you are only liable for part of a debt, you can deduct only your share of the total interest paid or accrued.

Example. You and your brother borrow money. You are liable for 50% of the note. You use your half of the loan in your business, and you make one-half of the loan payments. You may deduct your half of the total interest payments as a business deduction.

Partial payments on a nontax debt. If you make partial payments on a debt (other than a debt owed IRS), the payments, in the absence of any agreement between you and the lender, are applied first to interest and any remainder to principal. You can deduct only the amount that is interest.

Unstated interest. If you make payments on an installment purchase on which no interest or low interest is charged part of the payment is considered to include unstated interest. You calculate this unstated interest in the same way that original issue discount is figured for debt instruments issued after July 1, 1982. In this case, the issue price of the debt instrument (or contract) is its stated redemption price at maturity. Generally, unstated interest on contracts before this date is figured under section 483 of the Internal Revenue Code. See Publication 537, *Installment Sales.*

Interest You May Not Deduct

Some interest payments may not be deducted. In addition, certain other expenses that seem to be interest are not interest and are not deductible as interest.

Payment of interest by cash or equivalent. A cash method taxpayer may not deduct interest unless it is paid in cash or its equivalent. Therefore, if you are a cash method taxpayer you can not deduct interest you pay with funds you get from the original lender through a second loan, an advance, or any other arrangement similar to a loan, until you start making payments on the new loan. As you make payments on the second loan, first apply them to the interest on the first loan (and then to the first loan's principal). All amounts that you apply to the interest of the first loan are deductible (along with any interest you pay on the second loan) subject to any applicable limits.

Capitalized interest. There are certain interest expenses that you must capitalize rather than deduct. These are discussed later under *Interest Capitalization.*

If you buy property and pay interest owed by the seller (for example, by assuming the debt on the property), you may not deduct the interest. You should add the amount you paid for the interest that the seller owed to the basis of the property.

Commitment fees or standby charges. Fees that you incur to have business funds made readily available to you over a period of time, but not for the actual use of the funds, are not deductible as interest payments.

If you borrow the funds, these fees are a cost of getting your loan, and you can deduct a part of the fees in each tax year during the period of the loan. To figure your deduction for each tax year, divide the part of the loan period falling within the tax year by the total loan period. Then multiply this answer by the total amount of the fees. If you do not take out a loan, you can take a loss deduction for these fees in the year that your right to borrow the funds expires.

Example. The TRA company is constructing a warehouse. As various sections of it are finished, TRA must have money available to pay the contractor. TRA finances the building's $3 million cost through a 3-year construction loan with a bank. Under this agreement, the bank lends money to the TRA company as TRA needs it to pay the contractor.

The TRA company agrees to pay a $30,000 fee for the arrangement. TRA pays the fee on October 2, 1990, and receives the first draw. To figure the deductible amount of the $30,000 payment, TRA takes the number of months it had the money during the tax year (3) and divides it by the number of months of the loan (60). The result is multiplied by the commitment fee ($30,000) to show how much can be deducted in 1990 ($2,500).

Income tax owed. Interest paid or accrued on income tax assessed on your individual income tax return is not a business deduction even though the tax due is related to income from your trade or business. This interest is treated as a business deduction only in figuring a net operating loss deduction. See Chapter 20.

Penalties. Penalties on deficiencies and on underestimating tax are not interest and can not be deducted. Fines and penalties are not deductible.

Interest relating to tax-exempt income. Generally, interest relating to tax-exempt income is not deductible. No deduction is allowed for:

1) Interest on a debt incurred to buy or carry tax-exempt securities,
2) Amounts paid or incurred in connection with personal property used in a short sale, or
3) Amounts paid or incurred by others for the use of any collateral used in connection with a short sale.

If you deposit cash as collateral in a short sale and the cash does not earn a material return during the period of sale, item (2) above does not apply. For more information on short sales, see Publication 550, *Investment Income and Expenses.*

Limit on investment interest. Your interest expense deduction is limited if your investment interest expense is more than your net investment income. This rule applies only if:

1) You are a noncorporate taxpayer (including shareholders and partners of S corporations and partnerships), and
2) You paid or accrued interest on money that you borrowed to buy or carry property held for investment (including amounts allowable as a deduction in connection with personal property used in a short sale).

For more information about the limit on the investment interest expense deduction, see Publication 550.

Interest Capitalization

Under the uniform capitalization rules, you must generally capitalize interest on debt used to finance the production of real or tangible personal property. The property must be used in your trade or business or held for sale to customers. Interest on a debt on property that was acquired and held for resale does not have to be capitalized. Interest you paid or incurred during the production period (defined later) must be capitalized if the property produced is ***qualified property.*** Qualified property is:

1) Real property,
2) Personal property with a class life of 20 years or more,
3) Personal property with an estimated production period of more than 2 years, or
4) Personal property with an estimated production period of more than one year if the estimated cost of production is more than $1 million.

Under this rule, you are considered to have produced property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property.

Production period. For real property, the production period begins when physical activity is first performed on the property. This includes the grading or clearing of land and the excavation of foundations or utility lines. For all other property, the production period begins on the date the total production costs that have been incurred (including planning and design costs) equal or exceed 5% of the total estimated production costs (including planning and design costs) allocable to the property. The production period ends when the property is ready to be placed in service or held for sale.

Capitalized interest. Capitalized interest is treated as a cost of the property produced. This interest is recovered when the property is sold, used, or otherwise disposed of under the rules that apply to such transactions.

Capitalized interest is recovered through cost of goods sold, an adjustment to basis, depreciation, amortization, or other method.

Interest capitalization applies to interest you paid or incurred on any debt allocable to the costs of producing qualified property that must be capitalized under Internal Revenue Code sections 263A or 460. For example, these costs would include planning and design activities which are generally incurred before the production period begins, as well as the costs of raw land and materials also acquired before the production period begins. Also, they would include any costs incurred under a contract for property produced by a third party.

Allocating interest. To determine the amount of interest to be capitalized on qualified property, first capitalize the interest on debt directly allocable to the property's costs of production (traced debt). Next assign any other debt to the remaining costs of production. Then capitalize the interest on that debt to the extent the interest could have been reduced if the costs of production had not been incurred (avoided cost debt).

Also, you may not reduce the amount of interest expense you must capitalize by any interest income you earned on unspent debt proceeds you temporarily invested.

Traced debt. Generally, allocate traced debt to a particular cost by tracing payments made from the debt's proceeds to that cost. In this case, ***traced debt*** includes only:

Amounts of eligible debt (defined later) that are equal to or less than the qualified property's accumulated production costs, and

Debt that is directly attributable to the production of qualified property.

See *Election to avoid tracing requirement,* later in this chapter.

Eligible debt. This includes all of your debt, ***except*** for any debt with:

1) Permanently nondeductible interest (such as tax-exempt interest),
2) Personal interest (such as investment interest),
3) Qualified home mortgage interest,
4) Interest incurred by a tax-exempt organization (unless related to that organization's unrelated trade or business), and
5) Interest attributable to a debt between you and certain related parties (or between such parties themselves), if the rate of interest is less than the applicable federal interest rate on the date issued. See Chapter 4 for information about related parties.

Avoided cost debt. If production costs for the property exceed the amount of your traced debt, you must assign the excess eligible debt to such excess production costs and capitalize the interest on that debt.

Next figure the interest to be capitalized under the ***avoided cost method***. That is, the amount of debt to be allocated to excess production costs is based on the interest expense that would have been avoided if production costs had not been made and such costs were used to repay your debt.

The avoided cost method assumes that such repayment of debt occurs, regardless of your subjective intentions or the facts and circumstances surrounding your operations. You can apply this method regardless of whether you actually would have used the amounts otherwise spent for production to repay the debt.

Example. Assume that you are engaged in the production of qualified property. Your production costs are $1,000,000. You have a $400,000 loan that is traced to these production costs. You have another loan of $1,200,000 which is an eligible debt, bearing interest at a 10% annual rate.

You must capitalize the interest incurred on the traced debt during the production period of the property. In addition, you must capitalize interest incurred on the avoided cost debt during that period, consisting of $600,000 of the $1,200,000 obligation, at a 10% annual interest rate. Treat this $600,000 portion of that loan as avoided cost debt regardless of the particular financial or regulatory accounting treatment of the debt, and regardless of the purpose for which, or when in time, you incurred the loan.

Interest rate on avoided cost debt. The interest rate on avoided cost debt is generally a weighted average of the interest rates on your eligible debt outstanding during the production period. It does not include debt that has been specifically traced to the production activity.

Advance payments. If you contract out your production activity and agree to make progress or advance payments to the contractor, you must capitalize the interest on the debt incurred during production that is allocable to the payments.

The contractor who produces the property for you must also capitalize interest costs related to that property to the extent that the production costs incurred by the contractor exceed your total payments for the property.

Property used in production. If you incur interest on a debt to finance any asset used in the production of property (for example, manufacturing equipment and facilities), you must also capitalize the interest to the extent that it is paid or incurred during the production of the property. If an asset is used in the production of property and for other purposes, capitalize only the portion of the interest allocated to the production activity.

Calculation methods. In figuring the amounts of traced or avoided cost debt, the interest on the debt, and the amount of accumulated production costs for which interest must be capitalized, you may use any reasonable method that you apply consistently. For example, you may use methods that involve the computation of daily, weekly, or monthly average debt balances, interest rates, or production costs. You may not, however, use a method of making these calculations which involves computations that are made less frequently than on a monthly basis, unless you can demonstrate that no significant difference in results occurs between the method you chose and a method based on monthly computations.

Election to avoid tracing requirement. Instead of determining and accounting for the amount of all traced debt under the rules described earlier, you may elect to treat all of your traced debt as debt under the avoided cost method, regardless of the actual disbursement of debt proceeds to specific costs. The way you figure your interest under the election may vary from year to year depending on your situation for that year.

Accumulated production costs more than eligible debt. If the accumulated production costs exceed the total of your eligible debt, add all of your otherwise traced debt to your other eligible debt and treat the total as avoided cost debt in figuring the amount of interest you must capitalize.

Eligible debt more than accumulated production costs. If your total eligible debt exceeds the accumulated production costs, allocate all of the trade or business debt to your production costs and capitalize the interest. You must capitalize the interest as you would with an avoided cost debt. If your eligible trade or business debt exceeds the production costs, capitalize a pro rata portion of the interest on this debt as you would avoided cost debt. ***Trade or business debt*** is eligible debt as described earlier, except that it does not include debt subject to the investment interest or passive activity limitations.

If your total production costs exceed your trade or business debt, you must also allocate your remaining eligible debt that is not trade or business debt to these production costs on a pro rata basis. But only do this to the extent of the excess. In this case, you are not required to use the allocation rules and avoid the tracing requirements regarding your trade or business debt.

Election requirements. If you were previously subject to the interest capitalization rules and elect to avoid the tracing requirements, you must obtain the permission of the Commissioner of the Internal Revenue Service to make such a change in accounting method. Use Form 3115, *Application for Change in Accounting Method,* and indicate that you are requesting this change under Section VII of Notice 88–99.

Partnerships and S corporations. The interest capitalization rules, described above, are applied first at the level of the partnership or S corporation, and then at the level of the partners or shareholders, to the extent that the partnership or S corporation has insufficient debt to support the production or construction expenses.

If you are a shareholder in an S corporation, you may have to capitalize interest that you incur during the tax year with respect to the production costs of the S corporation. Similarly, you may have to capitalize interest incurred by the S corporation with respect to your own production costs. See Internal Revenue Service Notice 88–99, 1988-2 CB 422. You must provide the required information to properly capitalize interest for this purpose in an attachment to the Schedule K–1.

If you are a partner in a partnership, you may have to capitalize interest that you incur during the tax year with respect to the production costs of the partnership. Similarly, you may have to capitalize interest incurred by the partnership with respect to your own production costs. See Internal Revenue Service Notice 88–99. You must provide the required information to properly capitalize interest for this purpose in an attachment to the Schedule K–1.

Related parties. Under the avoided cost method, interest capitalization also applies to the extent that a related party (to the taxpayer) produces qualified property.

For more information on the uniform capitalization rules, see Publication 538, *Accounting Periods and Methods,* and Publication 551, *Basis of Assets.*

When To Deduct Interest

If interest capitalization (discussed earlier) does not apply to you, deduct interest as follows.

Cash method. You can deduct only payments of interest that you actually made during the tax year. A promissory note you give as payment of interest is not deductible because it is a promise to pay and not an actual payment.

Prepaid interest. Under the cash method, you can not deduct any interest that is paid before the year it is due. Interest you pay that is properly allocable to a later tax year must be charged to a capital account. Treat an advance payment as paid in the period covered by the prepaid interest.

Discounted loans. If interest or a discount is subtracted from your loan proceeds, it is not a payment of interest and you can not deduct it when you get the loan. A cash-method taxpayer must spread this discount over the loan period and can deduct interest only when payments are made on the loan.

Refunds of interest. If you are a cash-method taxpayer who pays interest and then receives a refund for any part of the interest later in the same tax year, reduce your interest deduction by the amount of the refund. If you receive the refund in a later tax year, include the refund in income if the deduction for the interest reduced your tax. If part of the deduction for the interest did not reduce your tax, you do not have to include all of the refund in income.

Accrual method. You may deduct only interest that has accrued during the tax year.

Prepaid interest under the accrual method. If you pay interest in advance, you deduct it as it accrues over the period of the debt. This rule also applies to the amount subtracted on a ***discounted loan.***

Payments unlikely to be made. If interest payments are unlikely to be made because of your financial difficulty, you may still take a deduction for accrued interest.

Tax deficiency. Interest on a federal income tax deficiency asserted against a corporation accrues in the tax year the liability is finally determined if the deficiency was contested. If the corporation does not contest the deficiency, then the interest accrues in the year the tax was asserted and agreed to. Interest is deducted in the year it accrues.

However, if a corporation contests but pays the proposed tax deficiency and interest and the corporation does not designate the payment as a cash bond, then the interest is deductible in the year it is paid.

Related taxpayer. If you use the accrual method, you cannot deduct interest owed to a related person who uses the cash method, until payment is made and the interest is includible in the gross income of the person paid. If a deduction is denied under this rule, the rule will apply even if your relationship with the person ceases to exist before the interest is includible in the gross income of that person. See the definition of related taxpayers in Chapter 4.

However, you may deduct the amount if you pay it within 2½ months after the end of your tax year, if the amount is paid:

On debt incurred on or before September 29, 1983, or

Under a contract binding on September 29, 1983, and thereafter before the amount is paid or incurred.

Below-Market Interest Rate Loans

If you receive a below-market loan for your trade or business, you may be entitled to claim an interest expense in excess of any interest you may actually have paid or incurred. The lender would then have to report that amount as interest income.

A ***below-market loan*** is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally treated as an arm's-length transaction in which you, as the borrower, are treated as having received:

A loan in exchange for a note that requires the payment of interest at the applicable federal rate, and

An additional payment.

The additional payment is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction. You may have to report this payment as additional income depending on its classification.

For more information, see Chapter 6 in Publication 535, *Business Expenses.*

17. Insurance

You can deduct the cost of insurance for your business or profession as a business expense if the insurance is an ordinary and necessary expense in carrying on your trade or business. You cannot deduct the cost of certain life insurance. See *Life Insurance Policies,* later.

When to Deduct

You usually deduct premiums in the tax year to which they apply.

Cash method. If you use the cash method of accounting and you pay a premium for insurance that covers an earlier tax year, you can deduct the payment only in the tax year it is paid.

If you make an advance payment of a premium for an insurance policy that covers more than one tax year, you cannot deduct the entire premium in the year you make the payment even if you are a cash basis taxpayer. You can only deduct the part of the premium that applies to the current tax year. In each later tax year you deduct the part that applies to that year.

Example. You operate a business and file your returns on a calendar year basis. You bought a fire insurance policy on your building effective October 1, 1990, and paid in advance a premium of $1,200 for 2 years. On your 1990 return, you can deduct only the part of the total premium that applies to the 3-months' coverage in 1990. The part of the premium that applies to 1991 and 1992 can be deducted in those years. Since the total policy premium is $1,200 for 2 years, the yearly rate is $600, and the monthly rate is $50. For the 3-month period in 1990, you can deduct $150; for 1991, you can deduct $600; and for the 9-month period in 1992, you can deduct $450.

If you use the cash method of accounting and you do not pay the $1,200 premium until January 1991, you cannot deduct on your return for 1990 the $150 for that year. However, you can deduct $750 (the $150 that applies to 1990 plus the $600 that applies to 1991) on your return for 1991.

Accrual method. If you use the accrual method of accounting, your insurance expense deduction depends on when economic performance occurs. If you have a liability to make premium payments, economic performance generally occurs as the insurance protection is provided to you. See Chapter 4.

Dividends received. If you receive dividends from business insurance and in prior years you deducted the insurance premiums, the return of a part of the premiums as a dividend is income. However, see *Recovery of items previously deducted* in Chapter 7.

Deductible Premiums

You can deduct the following kinds of insurance premiums that are related to your business.

1) Fire, theft, flood, or other casualty insurance. See Chapter 25 for information on casualties and thefts.
2) Merchandise and inventory insurance.
3) Credit insurance to cover losses from unpaid debts. Report any proceeds from this insurance as ordinary income.
4) Employees' group hospitalization and medical insurance. However, your group health plans must provide continuation coverage to your employees and their beneficiaries when certain events occur. See Chapter 8 in Publication 535, *Business Expenses,* for more information about continuation coverage.
5) Employers' liability insurance.
6) Liability insurance that covers your liability for bodily injuries suffered by persons who are not your employees and for property damage to others.
7) Malpractice insurance that covers your professional personal liability for negligence resulting in injury or damage to patients or clients.
8) Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault. However, a partnership cannot deduct premiums paid for workers' compensation on behalf of partners, as amounts paid on behalf of employees. Partners are ***not*** considered employees of the partnership.
9) Contributions to a state unemployment insurance fund. You can deduct these contributions as taxes if they are considered to be taxes under state law.
10) Use and occupancy and business interruption insurance. This insurance pays you for lost profits caused by a business shutdown due to a fire or other cause. Report the proceeds as ordinary income.
11) Overhead insurance. This insurance pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness. Report the proceeds as ordinary income.
12) Employee performance bonds such as fidelity, indemnity, or other bonds that insure faithful performance by your employees. Offset amounts repaid under employee performance bonds against any theft, embezzlement, or other related loss.
13) Car and other vehicle insurance. This insurance covers liability, damages, and other losses from accidents involving vehicles used in your business. If you operate a vehicle partly for personal use, you can deduct only the part of your insurance premiums that applies to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you cannot deduct any car insurance premiums. See Chapter 15 for information on car expenses.
14) Self-employed persons' medical insurance. If you are self-employed, or if you own more than 2% of the outstanding stock of an S corporation, you may be able to deduct, as an adjustment to income on Form 1040, 25% of the amount you pay for medical insurance for yourself and your family. This deduction cannot be more than your net earnings from the trade or business under which the medical insurance plan is established. However, if you are both self-employed and an employee of another person eligible to participate in a subsidized plan maintained by your employer, you ***cannot*** deduct any

medical insurance payments as an adjustment to income. This also applies if it is your spouse who is employed, and you are eligible to participate in your spouse's plan. However, you can still include the medical insurance payments as part of your medical expenses on Schedule A (Form 1040) if you itemize your deductions. See Chapter 8 in Publication 535 for more information.

Nondeductible Premiums

You may incur expenses for insurance policies that cannot be deducted. The following are examples of some nondeductible premiums.

Cost of goods sold. Manufacturers, processors, and others who include a part of their business insurance premiums in cost of goods sold cannot deduct that part as a current business expense.

Self-insurance reserve funds. You cannot deduct amounts credited to a reserve you set up for self-insurance. This applies even if you cannot get business insurance coverage for certain business risks. However, your actual losses are deductible.

Loss of earnings. You cannot deduct premiums for a policy that pays for your lost earnings due to sickness or disability. The proceeds from the payback are not income. However, see the earlier discussion on overhead insurance under *Deductible Premiums*.

Life Insurance Policies

You cannot deduct premiums on a life insurance policy covering yourself, an employee, or any person financially interested in your business if you are directly or indirectly a beneficiary of the policy.

You can deduct the premiums if you are not a beneficiary and can show that they represent current pay. However, when added to the employee's pay, the total must be reasonable. The following discussions illustrate some instances in which expenses for life insurance associated with your trade or business may or may not be deductible as a business expense.

Partners. If you are a partner in a partnership, you are considered to be a beneficiary if you take out an insurance policy on your own life and name your copartners as beneficiaries to induce them to retain their investments in the partnership.

Security for loan. If you take out a policy on your life or on the life of another person financially interested in your business to get or protect a business loan, you cannot deduct the premiums as business expenses. Nor can you deduct the premiums as interest on business loans or as expenses of financing loans. In the event of death, the proceeds of the policy are not taxed as income even if they are used to liquidate the debt.

Keyperson insurance. You can deduct premiums you pay or incur on a policy covering any officer, employee, or person financially interested in your business only if all of the following apply.

1) The payments are an ordinary and necessary business expense in the nature of additional compensation.
2) The total amount of all compensation, including insurance premiums, paid to that person is reasonable.
3) The policy is not beneficial to you either directly or indirectly.

Keyperson insurance premiums are wages subject to withholding, unless the policy is a group term policy, discussed later.

Increased efficiency of keyperson. If you insure the life of an officer or employee and you are not directly or indirectly a beneficiary under the policy, you do not lose your premium deduction just because you may benefit from the increased efficiency of the officer or employee insured.

Split-dollar life insurance plan. You cannot deduct your share of premiums paid on a policy on the life of an employee under a split-dollar plan. With this kind of plan you and your employee buy an insurance policy in which there is a large cash surrender value.

You pay the part of each premium equal to the increase in the cash surrender value of the policy, and your employee pays any balance. You are entitled to receive out of the proceeds of the policy an amount generally equal to the cash surrender value. The remainder goes to your employee's beneficiaries. The employee must include in gross income the value of the insurance protection that is more than the premiums paid by the employee.

Group term life insurance. You can deduct group term life insurance premiums paid or incurred by you on policies covering the lives of your officers and employees if you are not directly or indirectly the beneficiary under the contract.

Cost taxable to employee. An employee generally must include in income the cost of group term life insurance coverage on his or her life that is more than the cost of $50,000 of this insurance plus any amount paid by the employee toward its purchase. However, certain employees may also have to include in income the cost of the first $50,000 of this insurance. See Chapter 2 of Publication 535 for more information.

If the insurance includes permanent benefits, the cost of the permanent benefits minus the amount paid by the employee for the permanent benefits is included in the employee's income.

Permanent benefits are economic values extending beyond one policy year, such as paid-up insurance or cash surrender value, that are provided under a life insurance policy.

Withholding. The cost of group term life insurance that is income to the employee is not subject to income tax withholding. However, the cost is subject to social security tax withholding.

However, if your employee quit or retired before 1989, the cost of group term life insurance you provide the employee is not subject to social security taxes.

Form W-2. Employers must report on Form W-2 the cost that is includible in the employee's income. For information on Form W-2, see Publication 15 (Circular E), *Employer's Tax Guide*.

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18. Taxes

Important Changes for 1990

Self-employment tax. Beginning in 1990, you can deduct half of your self-employment tax when figuring your income tax.

You can deduct various taxes imposed by federal, state (including certain Indian tribal governments), local, and foreign governments if you incur them in the ordinary course of your trade or business and if they are directly attributable to that trade or business. Certain other taxes not attributable to your trade or business are deductible only if you itemize deductions on Schedule A (Form 1040).

If you conduct business as a sole proprietor, deduct your business taxes on Schedule C (Form 1040). A partnership deducts its business taxes on Form 1065 and a corporation on Form 1120, Form 1120–A, or Form 1120S.

Federal income, estate, and gift taxes and state inheritance, legacy, and succession taxes are not deductible.

If you use the cash method of accounting, your deduction for taxes can be taken only in the year paid. If you use the accrual method, your deduction can be taken only in the year the taxes are properly accruable.

Uniform capitalization rules apply to certain taxpayers in a trade or business who produce real or tangible personal property or acquire property for resale. Under these rules, certain expenses that are allocable to the property, including taxes, may have to be included in inventory costs or capitalized. For more information, see Chapter 6.

Deductible taxes. Taxes that are deductible are broken down into broad categories:

1) Real estate taxes;
2) State and local income taxes;
3) Employment taxes (see Chapter 33); and
4) Other taxes.

Real Estate Taxes

Real estate taxes are the taxes you pay on real property that you own. Ordinarily, you can deduct them, but sometimes you may elect to capitalize expenses for taxes as part of the cost of property (see Chapter 13). Sometimes you ***must*** capitalize expenses for real property taxes under the uniform capitalization rules. See Chapter 6.

Assessments. Assessments for ***local*** benefits that tend to increase the value of your property (such as assessments for construction of streets, sidewalks, and water and sewerage systems, or to provide public parking facilities) generally are not deductible. If the local benefit increases the value of your property, you must capitalize the assessment.

Local assessments for maintenance, repairs, or interest charges for benefits such as streets, sidewalks, and water and sewerage systems are deductible. If only part of the assessment is for maintenance, repairs, or interest, you must be able to show the amount so allocated.

Water bills, sewerage, and other service charges assessed against your business property are deductible as business expenses.

Example. City X, to improve downtown commercial business, converted a downtown business area street already improved by lights, sidewalks, sewers, etc., into an enclosed pedestrian mall. The full cost of construction, financed with 10–year bonds, was assessed against the affected properties. Payments of principal and interest made annually for 10 years, which is also the period of expected business advantage, are required from the property owners.

The assessments incurred by the property owners are not deductible as taxes, or as business expenses, but are depreciable capital expenses. Only the part of the payments that is to pay the interest charges on the bonds is deductible as taxes.

Sales. If real estate is sold, the deduction for real estate taxes must be divided between the buyer and the seller according to the number of days in the ***real property tax year*** (the period to which the tax relates) that each held the property. The taxes are apportioned to the seller up to but not including the date of sale, and to the buyer beginning with the date of sale, regardless of the accrual or lien dates under local law.

If you use the cash method and cannot deduct taxes until paid, and if the buyer of your property is personally liable for the tax, you are considered to have paid the part of the tax imposed for the part of the year up to the time of the sale. This permits you to deduct the part of the tax to the date of sale even though you do not actually pay it.

If you use the accrual method and have not elected to ratably accrue real property taxes, the taxes apportioned to you (but not deductible for any year under your accounting method) accrue on the date of sale.

Example. Al Green, a calendar year accrual method taxpayer, owns real property in X county but has not elected to ratably accrue property taxes. November 30 of each year is the assessment and lien date. He sold the property on June 30, 1990, and under his accounting method would not be able to claim a deduction for the taxes because the sale occurred before November 30. The part of the 1990 tax apportioned to him, 180/365 (January 1–June 29), is treated as having accrued on June 30, and is deductible for 1990.

Excess deduction. If you sell real property, the deduction you claimed last year may be greater than the taxes apportioned to you, as already discussed. If this occurs, the excess is included in your gross income to the extent provided in *Recovery of items previously deducted* in Chapter 7.

Election to ratably accrue. An accrual method taxpayer may elect to accrue ratably real property taxes that are related to a definite period of time over that period of time.

Example. John Smith is a calendar year taxpayer who is on an accrual method. His real property taxes applicable to the fiscal year July 1, 1990, to June 30, 1991, amount to $1,200. The assessment and lien date is July 1.

If for 1990 John makes the election to ratably accrue the taxes, $600 of the taxes will accrue in 1990 and the balance will accrue in 1991.

Separate elections. An election may be made for each separate trade or business and for nonbusiness activities if accounted for separately.

The election to ratably accrue real property taxes is binding unless the consent of the IRS is obtained to change the method of deducting real property taxes.

Any real property taxes that are normally deductible for the tax year, and that apply to periods prior to the year of the election, are deductible for the tax year in which you make the election.

Making the election. If you make your election for the first year in which real property taxes are incurred, the election may be made in a statement attached to your income tax return for that year. The return must be filed by the regular due date (including extensions). The statement should indicate:

1) The trades or businesses to which the election applies, and the accounting method or methods used;
2) The period of time to which the taxes relate; and
3) The computation of the real property tax deduction for the first year of election.

For any other year, you must secure the consent of the IRS to make the election for the change. To request the consent, complete Form 3115, *Application for Change in Accounting Method,* and file it with the IRS. This form should be filed within 180 days from the beginning of the tax year for which the election is to be effective, and you may have to pay a user fee of $500. See the instructions for Form 3115 for more information.

Limitation on accrual of taxes. A taxing jurisdiction can require the use of an earlier date for accruing taxes than that which was previously required. However, the accrual date for federal income tax purposes is the date on which the tax would have accrued had no action been taken.

State and Local Income Taxes

State income taxes imposed on a corporation are deductible by the corporation. However, state income taxes are not deductible by an individual as expenses of the business, but they can be deducted in computing the individual's income tax liability if deductions are itemized.

A state tax on gross income (as distinguished from net income) directly attributable to a trade or business carried on by an individual or a partnership is deductible as an expense of the business.

Accrual of additional state income taxes. If an accrual method of accounting is used and liability is contested, any increase in such deductible business taxes for a previous year will accrue and be deductible in the year the amount is finally determined.

Filing a state tax return is not considered contesting a liability for additional state income taxes assessed against taxpayers for prior years. Therefore, without some objective act of protest or evidence of denial of liability by an accrual method taxpayer, any additional state taxes assessed for a prior year is deductible for the prior year, rather than in the year the amount is finally determined.

However, a taxpayer who uses a consistent method of accounting to deduct additional prior year state taxes (including uncontested ones) in the year they are finally determined may continue to use that accounting method and deduct the additional taxes in the year finally determined. If that taxpayer deducts the additional taxes against income of the prior year, a credit or refund will be allowed only if the taxpayer received permission from the IRS to change the accounting method.

Other Taxes

In addition to real property taxes and income taxes, there are other taxes that can be deducted such as personal property tax and sales tax if they are incurred in the ordinary course of your trade or business. Beginning in 1990, half of your self-employment tax can also be deducted.

Personal property tax. You can deduct any tax imposed by a state or local government on personal property used in your trade or business. Normally, personal property taxes are *ad valorem* —that is, based on the value of the property.

You can deduct ***registration fees*** imposed by a state or local government for the right to use property within the state in your trade or business. If the fee is based on value, you can deduct it as a personal property tax.

Sales tax. An individual cannot deduct state and local sales tax as an itemized deduction. However, if you pay or accrue sales tax on the purchase of property, the tax is treated as part of the cost of the property. Thus, if you acquire depreciable property for use in a business, any sales tax paid or accrued on the purchase is added to the basis of the property and treated as part of the property's cost for depreciation purposes. If you buy a nondepreciable item that is deductible as a business expense, the sales tax on the purchase is still deductible as a business expense.

Sales tax imposed on sales of property or services at retail and measured by gross sales price or gross receipts may be deductible. Rentals qualify as sales if so treated under local law.

Sales taxes collected and paid over to the state are not deductible if you have not included them in gross receipts. If you have, you may take a deduction for them when you pay them over to the state. Because the various states and local jurisdictions have different requirements for collection of sales taxes, you should contact the taxing authorities in your area for sales tax regulations.

Sales tax imposed on the seller or retailer. If state law imposes the sales tax on the seller or retailer and allows the seller or retailer to state it separately or pass it on to the consumer, that consumer may deduct, as a business expense, the sales tax paid in purchasing property used in a trade or business, provided that the property is not a capital item (generally, a depreciable asset) or an inventory item. If the property is a capital item or an inventory item, the consumer (business person) must treat the sales tax as part of the cost of the item.

Use tax. A compensating use tax can be deducted as a sales tax. This tax generally is imposed on the use, storage, or consumption of an item brought in from another taxing jurisdiction. It is often imposed at the same rate as the general sales tax and is often complementary to a general sales tax that is imposed on sales of similar items in the taxing jurisdiction.

Self-employment tax. Beginning in 1990, you can deduct half of your self-employment tax when figuring your income tax. After you figure your self-employment tax on Schedule SE, *Social Security Self-Employment Tax*, deduct half of the tax on line 25 of your 1990 Form 1040.

Fuel taxes. Taxes on gasoline, diesel fuel, and other motor fuels that are used in your business usually are included as part of the cost of the fuel itself and are not deducted as a separate item.

Also, you may be entitled to a credit for tax paid on fuels used for certain purposes. See Publication 378, *Fuel Tax Credits and Refunds*.

State unemployment payments. As an employer, you may be required to make payments to a state unemployment compensation fund or to a state disability benefit fund. These payments are deductible as taxes.

Franchise taxes. Corporate franchise taxes are deductible as a business expense. If you are a cash-basis taxpayer, you may deduct the franchise tax in the year paid. If you are an accrual-basis taxpayer, you may take a deduction in the year you become legally liable to pay the tax, regardless of the year on which the tax is based. Thus, if your state imposes a franchise tax for 1990 that is based on your corporate net income for 1989, you may deduct the tax in 1990 because that is the year you became legally liable for the tax.

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19. Other Business Expenses

This chapter briefly covers some of the expenses you, as a person owning a business, may have that are not explained elsewhere in this publication. In order that you may find the different types of expenses more readily, they are in alphabetical order.

Generally, costs you incur to produce real or tangible personal property or to acquire property for resale must be capitalized or included in your inventory. Property acquired for resale is not subject to this rule if your annual gross sales are $10,000,000 or less. See Chapter 8 for more information.

Advertising expenses. You may deduct advertising expenses if they are reasonable and they are related to your business activities. You cannot deduct the cost of advertising if its purpose is to influence legislation.

Expenses for public service advertising which keeps your name before the community are usually deductible as an ordinary and necessary business expense if they are related to the amount of business you may reasonably expect to gain in the future. For example, the cost of advertising which encourages people to contribute to the Red Cross, to buy U.S. Saving Bonds, or to participate in similar causes usually will be deductible.

Foreign expenses. You may not deduct the costs of advertising on foreign radio and television (including cable) where the advertising is primarily for a market in the United States. However, this rule only applies to advertising expenses in countries that deny a deduction for advertising on a United States broadcast that is primarily for that country's market.

Anticipated liabilities. Anticipated liabilities or reserves for anticipated liabilities are not deductible. For example, assume that you sold one-year TV service contracts this year amounting to $50,000. From past experience you know that you will have expenses of about $15,000 in the coming year for these contracts. The television sets covered by the contracts were not sold by you nor by a person controlled by you.

You may not deduct any part of the $15,000 this year by charging expenses to a reserve or liability account. You can deduct your expenses only when you actually pay or accrue them depending upon your method of accounting.

Black lung benefit trust contributions. If you, as a coal mine operator, make a contribution to a qualified black lung benefit trust, you may be entitled to a business deduction for the amount of your contribution. To be deductible, your contribution must be made during the tax year or paid to the trust no later than the due date for filing your federal income tax return (including extensions). The contribution must be made in cash or property that the trust is permitted to hold. If you contribute property, the transaction is considered a sale or exchange of the property. A contribution to the trust in the form of a note or other evidence of your indebtedness is not considered a contribution to the trust.

You may figure your allowable deduction for contributions to a black lung benefit trust on Schedule A, Form 6069, *Return of Excise Tax on Excess Contributions to Black Lung Benefit Trust*.

Bribes and kickbacks. You may not deduct bribes, kickbacks, or similar payments if they are either of the following:

1) They are payments made directly or indirectly to an official or employee of any government or an agency or instrumentality of any government in violation of the law. If the government is a foreign government, the payments are not deductible if they are unlawful under the Foreign Corrupt Practices Act of 1977.
2) They are payments made directly or indirectly to a person in violation of any federal or state law (but only if that state law is generally enforced) that provides for a criminal penalty or for the loss of a license or privilege to engage in a trade or business.

Meaning of "generally enforced." A state law is considered to be generally enforced unless it is never enforced or is enforced only in the case of infamous persons or persons whose violations are extraordinarily flagrant. For example, a state law is considered to be generally enforced unless the proper reporting of a violation of the law does not result in enforcement except under unusual circumstances.

A kickback includes a payment for referring a client, patient, or customer. The common kickback situation occurs when money or property is given to someone as payment for influencing a third party to purchase from, use the services of, or otherwise deal with the person who pays the kickback. In many cases, the person whose business is being sought or enjoyed by the person who pays the kickback does not know of the payment.

Example 1. Mr. Green, an insurance broker, pays car dealers who refer insurance customers to him a part of the insurance commissions he earns. The car dealers are not licensed to sell insurance. If these payments are made in violation of any federal or state law, as explained in (2) above, Mr. Green may not deduct them.

Example 2. The Yard Corporation is in the business of repairing ships. It returns 10% of the repair bills to the captains and chief officers of vessels it repairs as kickbacks. The Yard Corporation considers kickbacks necessary to get business. The owners of the ships do not know of these payments.

In the state where the corporation operates, it is unlawful to attempt to influence the actions of any employee, private agent, or fiduciary in relation to the principal's or employer's affairs by giving or offering anything of value without the knowledge and consent of the principal or employer. The law is generally enforced. Therefore, the kickbacks paid by the Yard Corporation are not deductible.

Medicare or medicaid. Kickbacks, bribes, and rebates paid in connection with medicare or medicaid programs are not deductible.

File Form 1099–MISC. If you pay any kickbacks during your tax year, whether or not they are deductible on your return, you must file an information return, Form 1099–MISC, for every person to whom you pay $600 or more during the year.

Business use of your home. If you use part of your home exclusively and regularly as the principal place of business for your trade or business or as a place where you meet or deal with customers in your business, you may deduct the expenses for the part of your home used for business. Also, you may be allowed to deduct expenses for use of part of your home as a day-care facility or as a place to store inventory you sell in your business, even if that part of your home is sometimes used for personal purposes. For more information, see Publication 587, *Business Use of Your Home*.

Charitable contributions. Cash payments you make to charitable, religious, educational, scientific or similar organizations may be deductible as business expenses if the payments are not charitable contributions or gifts. If the payments are charitable contributions or gifts, you may not deduct them as business expenses. However, corporations may deduct charitable contributions on their income tax returns. See Chapter 29. If you are an individual, a partner in a partnership, or a shareholder in an S corporation, you may be able to deduct charitable contributions made by your business on your individual income tax return.

Example. You paid $15 to a local church for a half-page ad in a program for a concert it is sponsoring. Since your payment is not a contribution, you cannot deduct it as such. However, you may deduct it as an advertising expense.

Inventory. If you donate inventory, any inventory costs you had in earlier tax years which were included in opening inventory for the contribution year must be removed from the opening inventory account. They are not a part of cost of goods sold for purposes of figuring gross income for the year of contribution;

instead they are used in figuring the basis of the contribution.

Demolition expenses or losses. You cannot deduct any amount paid or incurred to demolish any structure, or any loss pertaining to the undepreciated basis of a structure. Instead, you must add these costs to the basis of the land on which the demolished structure was located.

Dues and subscriptions. You may deduct membership dues you pay to trade or professional organizations. You may also deduct dues you pay to the Chamber of Commerce if your membership promotes your business interests. However, if the dues are initiation or admission fees for membership, they are capital expenses.

Donations to other business organizations may be deducted as business expenses if they are directly related to your trade or business, and you reasonably expect a financial return that is in line with the amount of your donation.

For example, a contribution that you make to a committee organized by a chamber of commerce to bring a national convention to your city may be deductible. However, if a substantial part of the activities of the organization consists of lobbying, attempting to influence legislation, political campaigning, or carrying on propaganda or advertising for any of these purposes, you may deduct only the part of any payments you make to the organization that is not attributable to these activities.

The cost of subscriptions to professional, technical, and trade journals that deal with your business field is a deductible business expense.

Education expenses. There are two kinds of expenses for education that you may deduct. One of these is the ordinary and necessary expenses you pay for the education and training of your employees. These expenses are discussed in Chapter 10.

The other kind is for amounts you spend for your own education in your trade, business, or profession along with certain related travel, including meals (subject to the limitations discussed in Chapter 15), lodging, and transportation expenses. To qualify for a deduction, you must be able to show that the education maintains or improves skills that are required in your trade, business, or profession, or that it is required by law or regulations for keeping your pay, status, or job.

However, you may ***not*** deduct education expenses that you incur to meet the minimum requirements of your present trade, business, or profession or those that qualify you for a new trade, business, or profession, even if such education maintains or improves skills that are presently required.

Franchises, trademarks, trade names. Amounts you pay or incur to buy a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name are not deductible as business expenses, unless the payments are part of a series of payments which are:

1) Payable at least annually for the entire term of the transfer agreement, and
2) Substantially equal in amount (or payable under a fixed formula).

The term of the transfer agreement includes all renewal options, and any other renewal period for which the parties reasonably expect the agreement to be renewed.

A lump-sum payment of a principal amount agreed upon in a transfer that is not treated as a sale or exchange of a capital asset is deductible in equal amounts over the shorter of 10 years of the life of the agreement. However, for transfers after October 2, 1989, this 10–year period does not apply if the principal sum is over $100,000. All payments which are part of one transaction (or a series of related transactions) will be treated as payments with respect to each transaction.

Any payment which is not deductible because of these rules must be charged to a capital account. However, payments for franchises that must be charged to a capital account may be deductible over the life of the asset if the asset has a determinable useful life. Otherwise, the payment may be amortized over a 25–year period beginning with the tax year in which the transfer occurs, if you so elect. Payments allowed as a deduction under these rules are subject to recapture as ordinary income on the transfer, sale, or disposition of the asset.

Interview expense allowances. Reimbursements you make to job candidates for transportation or other expenses in connection with interviews for possible employment are not wages subject to social security taxes (FICA), federal unemployment taxes (FUTA), or income tax withholding. You may deduct such an allowance as a business expense if it qualifies as an ordinary and necessary expense of the business.

Legal and professional fees. Legal and professional fees, such as fees charged by accountants, that are ordinary and necessary expenses of operating your business are deductible as business expenses. However, legal fees you pay to acquire business assets usually cannot be deducted. They are added to the basis of the property.

If the fees you are charged for legal or professional services include payments for work of a personal nature (such as making out a will), you may deduct only the part of the fee that has to do with your business as a business expense. Some of the other fees may be deductible on Schedule A (Form 1040) if you itemize deductions. See Publication 529, *Miscellaneous Deductions*.

Licenses and regulatory fees. Licenses and regulatory fees for your trade or business that you pay each year to state or local governments are deductible.

Lobbying expenses. You may deduct expenses you have for appearing before, submitting statements to, or sending communications to the U.S. Congress, its committees, or its individual members, or to any legislative body of a state or political subdivision in connection with legislation or proposed legislation of direct interest to you in carrying on your trade or business. Your expenses of communicating with an organization of which you are a member about such legislative matters of direct interest to you and to the organization may also be deducted.

You may deduct the part of the dues you pay to an organization of which you are a member that is for the expenses of communicating information between the organization and the U.S. Congress, its committees, or its individual members, or to any legislative body of a state or political subdivision in connection with legislation of direct interest to that organization.

You may ***not*** deduct expenses paid or incurred to influence public opinion on any legislation, election, or referendum. The cost to a corporation of preparing, printing, and distributing a pamphlet to its stockholders urging action on their part to influence legislation is not deductible.

Losses recovered. If you receive an amount during the tax year as compensation for unrecovered losses, you may be allowed to take a special deduction. The deduction applies only to damages recovered from patent infringement, breach of contract or fiduciary duty, or antitrust injury that are included in gross income. The deduction for the year is the smaller of:

1) The amount you received or accrued for damages in the tax year reduced by the amount you paid or incurred in the year to recover that amount, or
2) The amount of your losses you had from the injury that you have not yet deducted.

The deduction applies only to recoveries for actual injury and not for any additional amount.

Medical expenses. If an expense is deductible either as a business expense or as a medical expense, you may deduct it as a business expense if:

Your work clearly requires that you incur the expense to satisfactorily perform the work; and

The goods or services purchased are clearly not needed or used, other than incidentally, in your personal activities.

Example. Because of a physical handicap, you are confined to a wheelchair. When you must attend out-of-town business and professional meetings you have your spouse, a friend, or a colleague go with you to help you overcome architectural barriers, carry your luggage, and accompany you on transportation that will not accept a wheelchair passenger unless the passenger is accompanied by an attendant. You do not need or use the services of a helper in the conduct of your personal or business activities in your hometown. You pay no salary to any of your helpers, but you do pay for their travel when they accompany you on trips.

Because your expenses for your helpers are intrinsically part of your travel expenses paid in connection with carrying on your business and they meet the tests listed above, you generally may deduct them as business expenses.

Moving machinery. The cost of moving your machinery from one city to another is a deductible expense. So is the cost of moving machinery from one plant to another or from one part of your plant to another part. You may also deduct the cost of installing the machinery in the new location. However, if you are installing or moving newly purchased machinery, these costs must be capitalized.

Penalties and fines. Penalties you pay for nonperformance of a contract or for late performance are generally deductible. For instance, if you contracted to construct a building by a certain date and had to pay an amount for each day the building was not finished after the date set for completion, you may deduct the amounts paid or incurred.

On the other hand, penalties or fines you pay to any government agency or instrumentality because of a violation of any law are not deductible. These fines or penalties include amounts:

Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding,

Paid as a penalty imposed by federal, state, or local law in a civil action, including additions to tax and additional amounts and assessable penalties imposed by the Internal Revenue Code,

Paid as a fine or penalty in settlement of actual or possible liability, whether civil or criminal, or

Forfeited as collateral posted in connection with a proceeding which could result in the imposition of a fine or penalty.

A few examples of nondeductible penalties and fines are:

Fines paid because of violation of city housing codes,

Fines paid by truckers because of violation of state maximum highway weight laws or air quality laws,

Civil penalties paid because of violation of federal laws regarding discharges into navigable waters or mining safety standards, and

Amounts paid to charitable organizations as a condition of probation by a federal district court. These amounts also are not deductible as charitable contributions.

The amount of a fine or penalty does not include legal fees and related expenses for the defense of a prosecution or civil action for a violation of the law imposing the fine or civil penalty. It does not include court costs or stenographic and printing charges. Compensatory damages paid to a government are not a fine or penalty.

Nonconformance penalty. You may deduct a nonconformance penalty assessed by the Environmental Protection Agency for failing to meet certain emission standards.

Political contributions. You may not deduct contributions or gifts you make to political parties or candidates as business expenses. In addition, expenses paid or incurred to take part in any political campaign on behalf of a candidate for public office are not deductible business expenses.

Indirect political contributions. You also may not deduct indirect political contributions and costs of taking part in political activities as business expenses. Some examples of these kinds of expenses are the following:

Advertising in a convention program of a political party, or in any other publication if any part of the proceeds from the publication is for, or is intended to be for, the use of a political party or candidate,

Admission to a dinner or program (including, but not limited to, galas, dances, film presentations, parties, and sporting events) if any part of the proceeds from the function is for, or is intended to be for, the use of a political party or candidate, and

Admission to an inaugural ball, gala, parade, concert, or any similar event if it is identified with a political party or candidate.

Repairs. The cost of repairing or improving property you use in your trade or business is either a deductible expense or a capital expense. What you spend to keep your property in a normal and efficient operating condition is a deductible expense. But if what you spend adds to the value of your property or significantly increases its life, the cost must be capitalized. Although capital expenses generally cannot be deducted as expenses, they usually can be deducted over a period of time through depreciation deductions. See Chapter 5.

Repairs do not add to the value or usefulness of property, nor do they appreciably lengthen its life. They merely maintain the property in a normal efficient operating condition. The cost of repairs, including labor, supplies, and certain other items, is a deductible expense. However, the value of your own labor is ***not*** deductible.

Examples of repairs are:

Patching and repairing floors,

Repainting the inside and outside of a building,

Repairing roofs and gutters, and

Mending leaks.

Repair expenses that are allocable to the ***cost of goods sold,*** discussed in Chapter 8, may not be deducted again as business expenses. These expenses are reflected in cost of goods sold for the year the expenses are incurred. Improvements a lessee makes on rented property are discussed in Chapter 11.

Repayments (Claim of right). If you included an amount in your income because you thought you had an unrestricted right to it, and in a later year you have to repay all or part of it, a special rule may apply. Usually, you may deduct the repayment in the year in which you make it. If the income item gave rise to a deduction in the year you included it in income, any deduction for the amount you repay is limited to the net amount you included in income in the prior year.

The character of the deduction in the year of repayment depends on the character of the income you included in the earlier year. For instance, if you repay an amount previously reported as a long-term capital gain, the repayment is a long-term capital loss.

Example. You use the cash method of accounting. In 1989, you were involved in a lawsuit resulting from a contract dispute with Doe Corporation. The dispute was over how much was owed to you. The court decided in your favor for $2,000. Although Doe Corporation said it would appeal the judgment, it was ordered by the court to pay you immediately without restriction. As promised, Doe Corporation appealed the case and won. The appellate court reversed the lower court's judgment in June 1990. In 1990, you repaid the $2,000 you received in 1990.

You had to include the $2,000 in your income for 1989 because you had an unrestricted right to it. No deduction arose from the inclusion. In 1990 you may deduct the $2,000 repayment.

Repayment of more than $3,000. If the amount you repaid was more than $3,000, you should figure your tax two ways:

1) Figure your tax for this year claiming a deduction for the repaid amount.
2) Figure your tax for this year without deducting the repaid amount. Then reduce this tax by the amount your tax in the earlier year was increased because you included in income the amount you later had to repay.

Your tax is the amount in (1) or (2), whichever is less.

If you figure the tax for the year of repayment under method (2), the amount repaid may not be deducted in figuring a net operating loss for the year of repayment but is taken into account in figuring the decrease in tax for the prior tax year.

This discussion does not apply if your deduction results from sales of inventory items to customers in the ordinary course of your trade or business. Nor does it apply to sales returns and allowances and similar items. It does not apply to bad debt deductions nor to legal fees and other expenses you had in contesting the repayment of income you previously included.

How to account for these repayments. If you use the cash method and you want to claim a deduction in a later year for an item of income that you included in a prior year under a claim of right, you must actually repay the amount. If you constructively received and included in income an amount you never actually received, you may deduct that amount in the tax year in which you are required to give up your right to receive it. If you use any other accounting method, you may deduct the repayment only in the proper tax year under that accounting method.

Supplies and materials. You may deduct the cost of incidental supplies and materials, such as office supplies and wrapping paper, that you use in running your business. However, if you make unusually large purchases of these items, you may not be allowed to deduct the entire cost in the year you buy them.

You may also deduct the cost of books, professional instruments, equipment, etc., if you normally use them up in less than a year.

Utilities. Your business expenses for heat, lights, power, and telephone are deductible expenses. However, any part that is due to personal use is not deductible.

Telephone. If you have an office in your home, even though you are in business, you cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line you have in your home.

Cellular telephone. Any cellular telephone or similar telecommunications equipment placed in service in tax years beginning after December 31, 1989, is listed property. If listed property is not used more than 50% for qualified business use during any tax year, the section 179 deduction is not allowable and the depreciation deductions are limited. See *Partial Business Use of Listed Property* in Part II of Publication 534, *Depreciation.*

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20. Net Income or Loss

After figuring your business income and expenses, you are ready to figure the net income or net loss from your business. You do this by subtracting business expenses from business income. If your expenses are less than your income, the difference is net income. If your expenses are more than your income, the difference is a net loss.

If you have more than one business, you must figure your net income or loss for each business separately.

Sole proprietorship. If you are a sole proprietor, figure the net income or loss from your business on Schedule C (Form 1040). If your business has net income, it generally becomes part of your gross income on Form 1040. If your business has a net loss, it generally can be deducted from other income when figuring your gross income on Form 1040. For more information on sole proprietorships, see Chapter 27.

Partnership. A partnership figures its net income or loss on Form 1065. The partnership then allocates its net income or loss among its partners. If the partnership has net income, each partner's share is added into the partner's gross income on the appropriate forms for the partner, depending on whether the partner is an individual, a corporation, or other entity. If the partnership has a net loss, each partner's share is deducted when figuring the partner's gross income. For more information on partnerships, see Chapter 28.

S corporation. An S corporation figures its net income or loss on Form 1120S. It then allocates its net income or loss among its stockholders. If the corporation has net income, each stockholder's share becomes part of his or her gross income on Form 1040. If the corporation has a net loss, each stockholder's share is deducted when figuring gross income on Form 1040. For more information on S corporations, see Chapter 30.

Corporation. A corporation figures its net income or loss on Form 1120 or Form 1120–A. The corporation itself must pay tax on its earnings. It figures its taxable income from its net income or loss for the year. For more information on corporations, see Chapter 29.

At-risk loss limits. Special at-risk rules apply to most business or income producing activities. The main exception is certain equipment leasing by closely held corporations.

At-risk rules limit the amount of loss you may deduct to the amount you are considered to have at risk in an activity. Generally, you are considered to be at risk up to the amount of money and the adjusted basis of other property that you contribute to the activity, plus certain amounts borrowed for use in the activity.

You are considered at risk for amounts borrowed for use in the activity if you are personally liable for repayment of the amounts or if the amounts borrowed are secured by your property that is not used in the activity. However, you are not considered at risk for amounts borrowed for use in an activity from certain interested persons or persons related to interested persons.

For more information, see Publication 925, *Passive Activity and At-Risk Rules.*

Passive activity limits. If your loss is from a passive activity, after you have considered the at-risk limits, you must next consider the special passive activity rules that limit the amount of loss you can deduct when figuring your taxable income or an NOL. Generally, losses from passive activities that exceed the income from all other passive activities cannot be deducted in the tax year. Credits are similarly limited.

A ***passive activity*** generally is any activity involving the conduct of any trade or business in which you do not materially participate. See Publication 925 for a discussion of material particpation.

In addition, a ***rental activity*** is a passive activity. For information on the special treatment of rental losses, see Publication 925.

There are special rules for certain partnerships, corporations, interests acquired before October 23, 1986, and certain rental activities. For more information see Publication 925.

Activities not engaged in for profit. If your business activity or the activity you invest in is not carried on to make a profit, the deductions you can take for it are limited and no loss from it will be allowed to offset other income. Activities you do as a hobby, or mainly for sport or recreation, would be subject to this limit. So would an investment activity that is intended only to produce tax losses for the investors.

The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

Figuring the limit. If your activity is not carried on for profit, deductions are allowed only in the following order, only to the extent stated in the three categories, and only if you itemize them on Schedule A (Form 1040).

1) Deductions that you can take for personal as well as for business activities are allowed first and are deducted on the appropriate lines of Schedule A (Form 1040). All nonbusiness deductions, such as those for taxes, casualty losses (except for the first $100 of each loss plus 10% of your adjusted gross income), and interest belong in this category. The deduction for personal interest, other than certain mortgage interest, is limited to 10% of the total paid or incurred in 1990.

   Certain limits apply to mortgage interest. For information on these limits, see Publication 545, *Interest Expense.*

2) Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent that your gross income from the activity is more than the deductions you take (or could take) for it under the first category. Most business deductions, such as those for advertising, insurance premiums, utilities, wages, etc., belong in this category. The 90% of personal interest not deductible in the first category belongs in this category.

3) Business deductions that decrease the basis of property are allowed last, but only to the extent that the gross income from the activity is more than deductions you take (or could take) for it under the first two categories. The deductions for depreciation, amortization and the portion of a casualty loss not deductible in category (1) belong in this category. Where more than one asset is involved, depreciation and these other deductions must be divided proportionally among those assets.

Additional limit. The amounts in categories (2) and (3) are claimed as miscellaneous deductions on Schedule A (Form 1040) and are subject to the 2% of adjusted gross income limit. See Publication 529, *Miscellaneous Deductions,* for information on this limit.

Partnerships and S corporations. If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual stockholders' or partners' distributive shares.

Not for profit. In determining whether or not you carry on your activity for profit, your intentions are important, but all factors relating to your activity must be taken into account. No one factor or group of factors is decisive. Among the factors that are normally considered are the following:

1) Whether you carry on your activity in a business-like manner.
2) Whether the time and effort you spend on the activity indicates that you intend to make it profitable.
3) Whether you depend on income from the activity for your livelihood.
4) Whether your losses from the activity are due to circumstances beyond your control (or are normal in the start-up phase of the business).
5) Whether you change your methods of operation in an attempt to improve the profitability of the activity.
6) Whether the activity makes a profit in some years, and how much profit it makes.
7) Whether you, or your advisors, have the knowledge needed to carry on the activity as a successful business.
8) Whether you have been successful in making a profit in similar activities in the past.
9) Whether you can expect to make a future profit from the appreciation of the assets used in the activity.

Presumption that an activity is for profit. An activity is presumed to be carried on for profit if it produced a profit in at least 3 of the last 5 tax years including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are given extra time to produce just 2 years of profit. They are presumed to be carried on for profit if they produced a profit in at least 2 out of the last 7 tax years. You have a profit when the gross income from an activity is more than the deductions attributable to it.

If your business or investment activity passes this 3 (or 2)–years-of-profit test, it is presumed to be carried on for profit. This means that it will not come under the limits discussed here. You can take all of your business deductions from the activity, even for the years that you have a loss. You can rely on this presumption in every case, unless the Internal Revenue Service (IRS) shows it is not valid.

Using the presumption at a later time. If you are starting out in an activity and you do not yet have 3 (or 2) years showing a profit, you may want to take advantage of this presumption at a later time, after you have had the 5 (or 7) years of experience allowed by the test.

You can choose to do this by filing Form 5213, *Election to Postpone Determination as to whether the Presumption that an Activity is Engaged in for Profit Applies.* Filing this form postpones any determination that your activity is not carried on for profit until 5 (or 7) years have passed since you first started the activity. Form 5213 must generally be filed within 3 years after the due date of your return for the year in which you first carried on the activity.

The benefit gained by making this choice is that the IRS will not immediately question whether the activity is engaged in for profit. Accordingly, it will not restrict your deductions. Rather, you will gain time to earn a profit in 3 (or 2) out of the first 5 (or 7) years you carry on the activity. If you show 3 (or 2) years of profit at the end of this period, your deductions will not be limited under these rules. If you do not have 3 (or 2) years of profit, the limit may be applied retroactively to any year in the 5–year (or 7–year) period that you had a loss.

Filing Form 5213 automatically extends the statute of limitations on every year in the 5–year (or 7–year) period to 2 years after the due date of the return for the last year in the period. The statute is extended only for deductions attributable to the activity and any related deductions which might be affected.

For more information on activities not engaged in for profit, see Publication 535, *Business Expenses.*

Deductible loss. If you have a net loss and it is deductible, you may have a net operating loss. The remainder of this chapter discusses what a net operating loss is, and how to figure and use one.

Net Operating Loss

If your deductions for the year are more than your income for the year, you may have a net operating loss (NOL). However, certain deductions are not considered in computing an NOL. See *How To Figure an NOL,* discussed later.

For your net loss for the year to be considered an NOL, it must be caused by:

1) Deductions from a trade or business,
2) Deductions you take in connection with your work as an employee, or
3) Deductions for casualty and theft losses.

A loss from operating a business is one of the most common reasons for an NOL. In determining the amount of the NOL, there are limits on both the kinds and the amounts of deductions you can take. These limits are different for individuals and corporations.

An NOL can be used to offset income in other tax years. If you carry back an NOL, you must refigure your tax for the year to which you carry the NOL. If you then owe less tax than you paid for that year, you can get a refund.

Before your loss can be deducted as an NOL, it may be limited by other rules. It may be limited, for example, by the at-risk rules or by the passive activity rules. For an explanation of those rules, see Publication 925. Your loss may even be considered to have resulted from a not-for-profit activity (discussed earlier) and would, therefore, be treated as a nondeductible loss.

NOL Steps

In general, figuring and using an NOL involves ***three steps.***

First. Determine whether or not you have an NOL for an "NOL year," and its amount. See *How To Figure an NOL.*

Second. Figure how much of that NOL is an ***NOL carryback*** or an ***NOL carryover.*** In this second step, determine which years you may carry the NOL to, and whether to carry it back or only forward. See *When To Use an NOL.* Also determine how much of the NOL may be carried to these "carryback" or "carryover" years. The amount you carry to a tax year is the NOL that was not used up in computing the income of an earlier tax year, which you figure by subtracting the "modified taxable income" of the earlier year from the NOL. See *How To Use an NOL.*

Third. Determine the ***NOL deduction*** for any year to which you carried an NOL, and use that deduction to figure your tax liability for that year. Your NOL deduction is the total of your NOL carrybacks and carryovers to a tax year. See *NOL Less Than Taxable Income.*

Note. If you are carrying NOLs from more than one NOL year, begin by completing the first two steps for the NOL from the earliest year. Next complete the first two steps for the NOL from the next earliest year, and so on in sequence. Then complete the third step.

The following sections of this chapter discuss NOLs—how to figure them, how to carry them to other years, and how to deduct them in those years.

How To Figure an NOL

In general, you figure an NOL the same way you figure taxable income. Start with your gross income and subtract your deductions. If your deductions are more than your gross income, you have a potential NOL.

There are rules that limit what you can deduct when figuring an NOL. In general, these rules do not allow personal exemptions, net capital losses, nonbusiness losses, or nonbusiness deductions to produce an NOL. However, there are a wide variety of deductions, including casualty and theft losses and employee expenses that you may treat as "business" rather than "nonbusiness" deductions.

Business income. This is income you receive from your trade or business. In figuring an NOL, treat the salary or wage you earn as an employee as income from a trade or business. In addition, include any gain from the sale or exchange of depreciable property or real estate you use in your business as business income.

Business deductions. These are ordinary and necessary in carrying on your trade or business. In figuring an NOL, you also treat certain other deductible expenses as business deductions. These expenses include—

Personal casualty and theft losses;
Moving expenses;
The deductible portion of employee expenses, such as:
  Travel,
  Transportation,
  Union dues, and
  Work clothes required in your work;
State income tax on business profits; and
Interest and litigation expenses on state and federal income taxes related to your business income.

Several types of losses are also considered business deductions. These are:

Loss on property you rent out,
Loss on the sale or exchange of business real estate or depreciable business property,
Loss on the sale of accounts receivable, but only if you use the accrual method of accounting,
Loss on the sale of stock in a small business corporation, up to the amount of the loss that qualifies as an ordinary loss,
Loss from the sale or exchange of small business investment company stock up to the amount that qualifies as an ordinary loss.

Note. If your losses involve passive activities, the losses described above may be limited by the passive activity rules and not be available for inclusion in the NOL amount. See Publication 925 for more information.

Nonbusiness income. This is income that is not from a trade or business. This includes dividends, annuities, income from an endowment, and interest on investments.

Nonbusiness deductions. These are deductions that are not from a trade or business, and are not related to your employment. They include medical expenses, alimony, charitable contributions, and your contribution to a personal retirement plan or an individual retirement account. If you do not itemize your deductions, then your nonbusiness deductions would also include the standard deduction.

Business versus nonbusiness. To figure an NOL, it is necessary to separate business income and deductions from nonbusiness income and deductions.

Rules limiting deductions. In figuring an NOL, you may not be able to deduct some items that are deductible in figuring your taxable income. Other deductions must be adjusted. The deductions affected are:

Exemptions. You cannot claim your personal exemptions or exemptions for dependents.

NOL deduction. You cannot deduct any NOL carryovers or carrybacks from other years.

Nonbusiness capital losses. You may deduct nonbusiness capital losses only up to the amount of nonbusiness capital gains. Any excess of nonbusiness capital losses over nonbusiness capital gains cannot be deducted.

Nonbusiness deductions. Nonbusiness deductions may be subtracted only from nonbusiness income, including any nonbusiness capital gains that remain after deducting nonbusiness capital losses. If your nonbusiness deductions are more than your nonbusiness income, you cannot deduct the excess.

Business capital losses. You may deduct business capital losses only up to the total of your:

Business capital gains, plus
The amount that results from subtracting the total of nonbusiness capital losses, personal exemptions, and nonbusiness deductions from nonbusiness capital gains.

A net capital loss cannot be deducted.

Example. In addition to his business income and deductions, Bob Green has ordinary nonbusiness income of $7,500 and nonbusiness capital gains of $13,000. He has ordinary nonbusiness deductions of $9,000 and nonbusiness capital losses of $7,000.

Bob's ordinary nonbusiness deductions exceed his nonbusiness income by $1,500 ($9,000 − $7,500). However, his nonbusiness capital gains exceed his nonbusiness capital losses by $6,000 ($13,000 − $7,000). Thus, Bob can use the $1,500 nonbusiness ordinary loss to offset part of his net nonbusiness capital gain. This leaves a net nonbusiness capital gain of $4,500 ($6,000 − $1,500).

If Bob had net business capital losses, he could use them to offset his remaining nonbusiness capital gain. However, if his net business capital losses exceeded $4,500, he could not include the excess as a part of his NOL deduction.

Schedule A (Form 1045). You can use Schedule A (Form 1045), *Computation of Net Operating Loss,* to figure your NOL.

The following example is an illustration of how to figure an NOL.

Example. In 1986, 1987, and 1988, Glenn Johnson had no taxable income. In 1989, he started a retail shoe business. He had an NOL of $185 for 1989 because of business losses during the first year. He elected not to carryback the 1989 NOL. For 1990, he is single and has the following income and deductions:

INCOME	
Salary earned as part-time helper in gas station	$ 1,225
Interest on savings	425
Net long-term capital gain on sale of real estate used in business	2,000
Glenn's total income	$ 3,650
DEDUCTIONS	
1989 net operating loss carryover	$ 185
Net loss from business (sales of $67,000 minus expenses of $72,000)	5,000
Net short-term capital loss on sale of stock	1,000
Personal exemption	2,050
Standard deduction	3,250
Small business investment company stock loss	300
Loss on small business stock	700
Glenn's total deductions	$12,485

Glenn's deductions exceed his income by $8,835 ($12,485 − $3,650). However, to figure whether he has an NOL, he must modify certain deductions.

Glenn cannot deduct the following:

1989 net operating loss carryover	$ 185
Nonbusiness net short-term capital loss	1,000
Personal exemption	2,050
The excess of his nonbusiness deductions (standard deduction amount, $3,250) over his nonbusiness income (interest, $425)	2,825
Glenn's adjustments to net loss	$6,060

When these items are eliminated, Glenn's deductions exceed his income by only $2,775 ($8,835 − $6,060). This amount is his NOL for 1990.

When To Use an NOL

Generally, you carry back an NOL to the 3 tax years before the NOL year, and then carry over any NOL remaining for up to 15 years after the NOL year. The "NOL year" is the year in which the NOL occurred. You may not deduct any part of the NOL remaining after the 15-year carryover period. See also *Forgoing the carryback period,* later.

After you determine which tax year to carry your NOL to, you will be able to figure the amount of your NOL deduction for that year and the unused part of the loss to be carried to the next tax year. You must first carry the entire NOL to the earliest carryback year unless you elect not to use the carryback period. This is explained later. Any NOL that remains after you reduce your modified taxable income for that year to zero can be carried to the next tax year.

If you do not use up the NOL in the 3 carryback years, carry what remains of it over to the 15 tax years following the NOL year. Start by carrying it over to the first tax year after the NOL year. If you do not use it up after subtracting your modified taxable income for that year, carry over the unused part to the next year. Continue to carry over any unused part of the NOL until you complete the 15-year carryover period.

Example. You started your business in 1990, and had a $42,000 NOL for the year. You begin using your NOL in 1987, the third year before the NOL year, as shown in the following chart. When figuring how much of the NOL is used up each year and how much may be carried to a later year, you must make certain modifications to your taxable income for each of the years to which the NOL was carried. These modifications are discussed later.

Year	Carryback or carry over	Modified taxable income	Unused loss
1987	$42,000	$2,000	$40,000
1988	40,000	3,000	37,000
1989	37,000	5,500	31,500
1990 (NOL year)			
1991	31,500	9,000	22,500
1992	22,500	9,800	12,700
1993	12,700	8,700	4,000
1994	4,000	6,000	-0-

Taxable income of year NOL is used in its entirety is not modified as explained later.

If your loss was larger, you would have been able to carry it forward until the year 2005. If you still had an unused 1990 carryover after the year 2005, you would not be allowed to deduct it.

Forgoing the carryback period. You can choose not to carry back your NOL. If you make this choice, you may then use your NOL only in the 15-year carryover period. To make this choice, attach a statement to your tax return for the NOL year. This statement must show that you are choosing to forgo the carryback period under section 172(b)(3)(C) of the Internal Revenue Code. You must file this statement by the due date, including extensions, for filing your return for the NOL year. If you do not file it on time, you cannot forgo the carryback period. Once you make this choice, you cannot change it.

If you want to forgo the carryback period for more than one NOL, you must make a separate choice for each NOL year.

Foreign expropriation losses. If part of your NOL is from the expropriation, intervention, or seizure of your property by a foreign government, you can only carry over that part of your NOL for up to 10 years following the NOL year. You can not carry it back. Any bad debt deduction for a business debt that becomes worthless because of the expropriation, intervention, or seizure of your property by a foreign government is also a foreign expropriation loss.

How To Use an NOL

After you determine which year to carry your NOL to, you must figure how much of it is available as a carryback or carryover to that year.

If you have not already carried the NOL to an earlier year, then your NOL carryback or carryover is the total amount of the NOL. If you carried the NOL to an earlier year, then your NOL carryback or carryover is the amount of the NOL minus the amount you used in the earlier year or years.

For a carryback to 1987, 1988, or 1989, or a carryover to 1990, you should deduct all of your NOL if it is ***equal to or less than*** your taxable income (line 36 of Form 1040 for 1987, line 37 for 1988, 1989, and 1990). If your NOL is less than your taxable income, you will have to refigure your tax. See *NOL Less Than Taxable Income,* later.

If your NOL is ***more than*** the taxable income of the year to which it is carried, you must make certain modifications to that taxable income to determine how much loss will be used up in that year and how much loss can be carried to the next tax year. The amount you may carry to another year, after applying it in an earlier year or years, is the excess of your NOL over the modified taxable income of the earlier year or years.

If you carry NOLs from more than one year to the same year, figure the amount that has been used up for each NOL separately, starting with the NOL from the earliest NOL year. In other words, first figure the modified taxable income you will subtract from the NOL that came from the earliest NOL year, to get the carryback or carryover from that year. Then figure the modified taxable income you will subtract from the NOL from the next earliest NOL year to get the carryback or carryover from that year, and so on. The sum of these carrybacks and carryovers will be your NOL deduction for the year.

Modified taxable income. If your NOL is more than the taxable income of the year to which it is carried, you must make certain adjustments to that taxable income to determine the modified taxable income of that year. The modified taxable income is used only to determine if there is any excess NOL to be carried to the next tax year. Do not use any of the adjustments to figure your NOL deduction or to redetermine your tax liability. If your NOL is more than the modified taxable income, carry the difference to the next tax year.

You arrive at modified taxable income in two steps. In step one, modify the deductions used in figuring adjusted gross income. In step two, modify the deductions that are subtracted from adjusted gross income to arrive at taxable income. Use the following guide to these modifications.

Step one. Figure adjusted gross income as you normally would for the carryback or carryover year, but with the following three modifications:

1) You can deduct capital losses only up to the amount of capital gains. You cannot deduct any part of a net capital loss.
2) Do not deduct the NOL carried from your NOL year or from any later tax years. But be sure to deduct any allowed NOL carrybacks or carryovers from years before your NOL year.

   Note. If you carry two or more NOLs to a tax year, you must deduct them, when figuring modified taxable income, in the order they were incurred. First, deduct the NOL from the earliest year, then the NOL from the next earliest year, and so on. After you deduct each NOL, there will be a new, lower total for modified taxable income to compare with any remaining NOL.

Step two. Take the deductions from adjusted gross income that you are normally allowed, but with the following modifications:

1) You must use modified adjusted gross income (figured in ***Step one***) to figure the percentage limits on the deductions for

medical expenses, charitable contributions, miscellaneous expenses, and casualty losses.

Note. The deduction for charitable contributions is not changed because of an NOL carryback deduction. Therefore, any NOL carrybacks that you already deducted in figuring adjusted gross income must be added back to refigure the percentage limit on the deduction for charitable contributions.

2) You must deduct your total itemized deductions or your standard deduction.

3) You cannot claim your personal exemptions or exemptions for dependents.

Note. You may find after making these modifications that you arrive at a negative figure for modified taxable income. If so, treat the modified taxable income as zero.

Example. In calendar year 1990, you have an NOL of $16,000 that you carry back to 1987. You have no other carrybacks or carryovers to 1987. Therefore, your NOL carryback to 1987 is $16,000.

Your adjusted gross income in 1987 was $29,000, consisting of your salary of $30,000 minus a $1,000 capital loss deduction. You were single and claimed only one personal exemption, worth $1,900 in 1987. During that year you gave $17,000 in charitable contributions and had $2,725 in dental expenses. You also deducted $1,650 in taxes and $1,125 in home mortgage interest.

The deduction for charitable contributions is limited to 50% of adjusted gross income (.50 × $29,000 = $14,500). The deduction for medical expenses is limited to expenses over 7.5% of adjusted gross income (.075 × $29,000 = $2,175; $2,725 − $2,175 = $550). The deductions for taxes and home mortgage interest are not subject to any limits. You were thus able to claim $17,825 ($14,500 + $550 + $1,650 + $1,125) in itemized deductions for 1987. You had no other deductions in 1987. Your taxable income for the year is $9,275, computed as follows:

Salary		$30,000
Minus: Capital loss deduction		1,000
Adjusted gross income		$29,000
Minus net itemized deductions:		
Charitable contributions (adjusted to limit the deduction to 50% of $29,000 adjusted gross income)	$14,500	
Medical expenses (adjusted to limit the deduction to expenses in excess of 7.5% of $29,000 adjusted gross income)	550	
Taxes	1,650	
Home mortgage interest	1,125	
Total itemized deductions		$17,825
Remainder		$11,175
Minus: Personal exemption		1,900
Taxable income for 1987		$ 9,275

Because the $16,000 net operating loss you are carrying back to 1987 is more than your $9,275 taxable income as adjusted for 1987, you must figure your modified taxable income. Figure your modified taxable income for 1987 as follows:

Salary		$30,000
Minus: Capital loss deduction (none allowed)		-0-
Adjusted gross income		$30,000
Minus net itemized deductions:		
Charitable contributions (adjusted to limit the deduction to 50% of $30,000 adjusted gross income)	$15,000	
Medical expenses (adjusted to limit the deduction to expenses in excess of 7.5% of $30,000 adjusted gross income)	475	
Taxes	1,650	
Home mortgage interest	1,125	
Total itemized deductions		$18,250
Remainder		$11,750
Minus: Personal exemption (none allowed)		-0-
Modified taxable income for 1987		$11,750

Subtract your modified taxable income for 1987 ($11,750) from your NOL carryback from 1990 ($16,000) and carry the remaining $4,250 to 1988.

NOL Less Than Taxable Income

After you determine your NOL for the current tax year, as described earlier, you can use that amount to offset income in other tax years. The total of your NOL carrybacks and carryovers to a tax year is your NOL carried to that tax year. For information on carrybacks and carryovers, see *When To Use an NOL,* earlier.

Before you can compute your NOL deduction for a tax year, determine the NOL to be carried to that tax year. Generally, the amount you carry to a tax year is the NOL that was not used up in another tax year. See *How To Use an NOL,* earlier, for more information on determining the available NOL to be carried to a tax year.

After determining the amount of your NOL deduction for the year to which an NOL is to be carried, you are ready to figure your tax liability for that year. You deduct the NOL when figuring adjusted gross income for the carryback or carryover year. Because the NOL lowers your adjusted gross income, you may need to adjust your other deductions that are based on a percentage of adjusted gross income. The NOL deduction may also affect your tax credits and liability for the alternative minimum tax. See *Refiguring deductions, credits, and taxes in the carryback year,* for more information.

Refiguring deductions, credits, and taxes in the carryback year. If you carryback your NOL, you must refigure any deductions, such as medical expenses and casualty losses, that are affected by a percentage of adjusted gross income. Refigure these deductions using your new adjusted gross income. Do not refigure your deduction for charitable contributions. This deduction is not changed because of an NOL carryback deduction.

Next refigure your income tax for the year. Also refigure any alternative minimum tax you paid in the carryback year. However, ***do not refigure*** your self-employment tax.

If the period has expired for claiming a refund or credit for an unclaimed deduction in the carryback year, do not use that unclaimed deduction to figure how much of your NOL to deduct in the carryback year or how much of the NOL to carry to the next year. However, if the unclaimed deduction would have caused an NOL in the carryback year, you may carry that resulting NOL forward to any open years in which it could be deducted. You can use it to reduce your tax before deducting any NOL you incurred in a later year.

Finally, you must refigure any credits for the carryback year that are based on or limited by the amount of tax. Refigure these taxes and credits on the basis of your new tax liability.

Example. In 1990, you had an NOL of $8,000. Because you do not choose to forgo the 3–year carryback period, you carry your NOL back to 1987. You have no other carrybacks or carryovers to 1987.

Your adjusted gross income for 1987 was $15,000. It came from your salary and savings account interest. You did not have any capital gains or losses in 1987. You had a total of $4,885 for the year in itemized deductions, consisting of $2,500 in charitable contributions and $385 in medical expenses. You actually paid $1,510 in doctors' expenses, but the deduction was limited to expenses in excess of 7.5% of adjusted gross income. You also deducted $1,000 in taxes and $1,000 in home mortgage interest. You were able to deduct $4,885 in itemized deductions. You were single and claimed one personal exemption in 1987. Your tax of $1,162 for the year was based on taxable income of $8,215 ($15,000 − $4,885 − $1,900).

Because your $8,000 NOL carryback is less than $8,215, you can deduct all of your NOL carryback in 1987 without having to figure your modified taxable income.

You refigure your 1987 income tax to determine the amount of your refund as follows:

Adjusted gross income on 1987 return		$15,000
Minus: Net operating loss deduction from 1990		8,000
Adjusted gross income after carryback		$ 7,000
Minus itemized deductions:		
Charitable contributions (amount allowed on 1987 return)	$2,500	
Medical expenses ($1,510 of actual expenses minus 7.5% of adjusted gross income after carryback)	985	
Taxes	1,000	
Home mortgage interest	1,000	
Total itemized deductions		$ 5,485
Remainder		$ 1,515
Minus: Personal Exemption		1,900
Taxable income after carryback		$ -0-
Taxes paid on 1987 return		$ 1,162
Tax liability after carryback		-0-
Refund due		$ 1,162

Carryover. If you choose to forgo the carryback period, described earlier, you must first carry your NOL to the year following the NOL year. Then figure how much of your NOL you can deduct in a carryover year.

Forms. The form you use to deduct your NOL depends on whether you carry it back or you carry it over. However, whether you carry your NOL back or carry it over, you must attach a statement to your return that shows all the important facts about the NOL. Your statement should include how much was deducted and how you figured the deduction. If more than one NOL is deducted in the same year, your statement must cover each of them.

For a carryback. If you carry back your NOL, you can use either Form 1040X, *Amended U.S. Individual Income Tax Return*, or Form 1045, *Application for Tentative Refund*. You can get your refund quicker by using Form 1045.

To get a refund of taxes, file Form 1040X within 3 years of the due date, including extensions, for filing the return for the NOL year. For example, if you are a calendar year taxpayer and you filed your 1987 return by the April 15, 1988, due date, you must file a claim for a refund of taxes paid in 1984 because of an NOL carryback from 1987 by April 15, 1991.

If you prefer, you may apply for a quick refund by filing Form 1045. This form results in a tentative adjustment of tax in the carryback year. You must file Form 1045 on or after the date you file the return for the NOL year but not later than one year after the NOL year. For example, if you are a calendar year taxpayer with a carryback from 1990 to 1987, you must file Form 1045 on or after the date you file your tax return for 1990, but not later than December 31, 1991.

The IRS will ordinarily act on Form 1045 within 90 days from the day you file it.

If the IRS refunds or credits an amount to you on the basis of Form 1045 and later determines that the refund or credit is too much, the excess may be assessed and collected immediately.

For a carryover. If you carry over your NOL, you should list the amount of your deduction as a minus figure on line 22 of Form 1040 (for 1990). If NOLs from 2 or more years are carried over to the same year, add the carryovers and list the total on line 22.

Change in marital status. If you and your spouse have been married for each year involved in the computation of the NOL and file only joint returns (or if you only file separate returns) for each tax year involved in the computation of NOL carrybacks and carryovers, figure your NOL and the carryback or carryover according to the rules described earlier in this chapter. Special rules apply, however, for figuring the NOL carrybacks and carryovers of a husband and wife whose filing status changes for any tax year involved in computing an NOL deduction. For more information, see Publication 536, *Net Operating Losses*.

Partnerships and S Corporations

Partnerships and S corporations generally are not allowed to take an NOL deduction. But the partners or shareholders may use their separate shares of the partnership's or S corporation's business income and business deductions to figure their individual NOLs.

Corporations

A corporation generally figures and deducts an NOL the same way an individual does. The same carryback and carryover periods apply, and the same sequence applies when two or more NOLs are carried to the same year.

A corporation's NOL generally differs from an individual's in two ways.

1) A corporation is allowed to take different deductions when figuring an NOL, and
2) A corporation must make different modifications to its taxable income in the carryback or carryover year when figuring how much of the NOL will be used and how much to carry over to the next year.

Figuring an NOL. A corporation's NOL is figured the same way as its taxable income. Start with the corporation's gross income and subtract its deductions. If its deductions are more than its gross income, it has an NOL.

However, there are rules for computing the NOL that either limit what can be deducted, or permit deductions not ordinarily allowed. These rules are:

1) You cannot deduct any NOL carryback or carryover from other years;
2) You can take the deduction for dividends received, explained later, without limiting it to a percentage of the corporation's taxable income; and
3) You can figure the deduction for dividends paid on certain preferred stock of public utilities, without limiting it to the taxable income for the year.

Dividends-received deduction. A corporation can take a deduction for ***80%*** of dividends received or accrued if it owns 20% or more of the stock of the paying domestic corporation (by vote and value).

If a corporation owns less than 20% of the paying domestic corporation it can take a deduction for only ***70%*** of dividends received or accrued. Under prior law, before 1988, domestic corporations could generally take a deduction for 80% of dividends received or accrued from taxable domestic corporations.

Limit on deduction. The amount of the dividends-received deduction is generally limited to 70% or 80% of the taxable income of the corporation receiving the dividend.

However, if a corporation sustains an NOL for a tax year, the limitation of 70% or 80% of taxable income does not apply. In determining if a corporation has an NOL, the dividends-received deduction is figured without regard to the 70% or 80% of taxable income limitation.

See Chapter 29 for more information on determining the dividends-received deduction.

Example. A corporation had $500,000 gross income from business operations and $625,000 of allowable business expenses. It also received $150,000 in dividends from a domestic corporation in which it was a 20% owner. It figures its NOL as follows:

Income from business	$ 500,000
Dividends	150,000
Gross income	$ 650,000
Deductions (expenses)	625,000
Taxable income before special deductions	$ 25,000
Minus: Deduction for dividends received (not limited to 80% of taxable income) 80% of $150,000	120,000
Net operating loss	($ 95,000)

Using an NOL. A corporation figures how much of its NOL to deduct in the year it is carried to by subtracting from the NOL the modified taxable income of any earlier carryback or carryover years. If the NOL available for a carryback or carryover year is greater than the taxable income for that year, the corporation must modify its taxable income to figure how much of the NOL is used up in that year and how much may be carried to the next tax year.

Unless a corporation elects to forgo the carryback period, it must first carry the entire NOL to the earliest carryback year, then carry any excess NOL, after subtracting modified taxable income, to the next carryback year, and so on.

Ownership change. A loss corporation that has an ownership change is limited on the amount of taxable income that may be offset by NOL carryovers arising before the date of the ownership change. This limit applies to any year ending after the change of ownership.

See section 382 of the Internal Revenue Code and the related Temporary Regulations for more information about the limits on corporate NOL carryforwards and corporate ownership changes.

Modified taxable income. Modified taxable income is figured in the same way as taxable income. But you must figure the corporation's deduction for charitable contributions without considering any NOL carrybacks.

Modified taxable income is used only to figure how much of an NOL is used up in the carryback or carryover year and how much to carry to the next year. It is not used to fill out the corporation's tax return or figure its tax.

When you figure modified taxable income, you may deduct only NOLs from years before the year of the NOL being carried back or over.

Taking the deduction. The form that is used to deduct the corporation's NOL depends on whether you carry it back or over.

For a carryback. If you carry back the corporation's NOL, you can use either Form 1120X, *Amended U.S. Corporation Income Tax Return*, or Form 1139, *Corporation Application for Tentative Refund*. The corporation can get a refund quicker by using Form 1139. You cannot file Form 1139 before you file the return for the corporation's NOL year. But you must file it no later than one year after the NOL year.

Form 1120X must be filed within 3 years of the due date, plus extensions, for filing the return for the year the corporation has the NOL.

For a carryover. If you carry over the corporation's NOL, enter it on line 29a of Form 1120 or line 25a of Form 1120–A.

Carryback expected. If a corporation expects to have an NOL in its current year, it may automatically extend the time for payment of all or part of its income tax for the immediately preceding year. It does this by filing Form 1138, *Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback*, with a statement showing why it expects the loss. This statement must comply with the instructions on Form 1138.

Period of extension. The extension is in effect until the end of the month in which the return for the NOL year, plus extensions, is due.

If the corporation files Form 1139 before this date, the extension will continue until the date the IRS notifies the corporation that its Form 1139 is disallowed in whole or in part.

Part V
Disposing of Business Assets

If you sell a business asset, exchange it for another asset, or dispose of it in some other way, you may have to report a gain or a loss. Gains and losses may be capital or ordinary. If capital, they may be long-term or short-term. However, some kinds of exchanges result in nontaxable gains and nondeductible losses.

The rules for reporting sales and other dispositions of business assets are given in this Part. These rules are important in planning future transactions. Several options may be open to you, each producing different tax results.

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21. Sales and Exchanges

Important Changes for 1990

Like-kind exchanges. Restrictions have been added to the rules allowing a tax-free exchange of like-kind property. If related parties exchange like-kind property, they must wait 2 years before either can sell or dispose of the property exchanged.

Foreign for U.S. real property exchange. If U.S. real property is exchanged for foreign real property, the exchange is not a tax-free exchange because the properties are not of a like-kind.

New Form 8824. Beginning in 1990, if you exchange property in a like-kind transaction, you must file Form 8824, *Like-Kind Exchanges,* in addition to Schedule D (Form 1040) or Form 4797.

Sales and exchanges of property generally result in taxable gains or deductible losses. However, some exchanges of property are nontaxable and some losses are not deductible. An exchange of property for like property is the most common type of transaction in which no gain or loss is recognized.

A ***sale*** is a transfer of property for money or for a mortgage, note, or other promise to pay money. An ***exchange*** is a transfer of property for other property or services. The rules for figuring a taxable gain or a deductible loss apply to both sales and exchanges.

Stock in trade. Stock in trade and other property held mainly for sale to customers in a trade or business are discussed in Chapter 8.

Installment payments. These payments are often made under a sales contract. See Chapter 24.

Sale or lease. It is important to distinguish a lease from a conditional sales contract. See *Lease or purchase* in Chapter 11.

Cancellation or sale of a lease. Payments received by a tenant for the cancellation or sale of a lease may result in a gain or loss from the sale or exchange of a capital asset or property treated as a capital asset. If the lease was used in the tenant's trade or business, the gain or loss is a section 1231 gain or loss as discussed in Chapter 22. Payments received by a landlord (lessor) for the cancellation of a lease are ordinary income.

Easements. Granting or selling an easement is usually not a taxable sale of property. Instead, the amount received for the easement is subtracted from the basis of the property. If only a part of the entire tract is permanently affected by the easement, only the basis of that part is reduced by the amount received. If it is impossible or impractical to separate the part of the basis of the property on which the easement is granted, the basis of the whole property is reduced by the amount received.

Any amount received that is more than the basis to be reduced is a taxable gain. The transaction is reported as a sale of property.

A transfer of property to satisfy a debt. A transfer of property to satisfy a debt is a taxable exchange.

Extended note maturity date. The extension of the maturity date of notes is not treated as an exchange of outstanding notes for new and different notes. It is not a closed and completed transaction upon which a gain or a loss is figured. This treatment applies to notes you hold under an agreement that states you will not redeem your notes during any extension period but will keep them until all other notes are retired or the notes can be retired.

Nontaxable transactions. A transaction may be a nontaxable exchange when you sell property used in your trade or business, immediately buy similar property to replace it, and the sale and purchase are mutually related transactions. Whether a sale and purchase is a nontaxable exchange, however, depends on the facts.

Example. You used a car in your business for 2 years. Its depreciated basis is $3,500 and its trade-in value is $4,500. You are interested in a new car that cost $10,500. Ordinarily, you would trade your old car for the new one and pay the dealer an additional $6,000. Your basis for depreciation for the new car would then be $9,500 ($6,000 cash paid plus $3,500 basis for the old car, see Chapter 6).

Because you want your new car to have a larger basis for depreciation, you arrange to sell your old car to the dealer for $4,500 and buy the new car for $10,500 from the same dealer. However, you will be treated as having exchanged your old car for the new one because the sale and purchase were reciprocal and mutually dependent. Your basis for depreciation for the new car will be $9,500, as if you traded the old car.

Involuntary exchanges. An involuntary exchange is the destruction, theft, condemnation, or disposal under the threat of condemnation of your property if you receive other property or money in payment, such as insurance or a condemnation award. See Chapter 25 for more information.

Contributions to a partnership. Contributions you make to a partnership in exchange for an interest in it are discussed in Chapter 28.

Gain or Loss from Sales and Exchanges

A ***gain*** is the excess of the amount you realize from a sale or exchange over the adjusted basis of the property you transfer. A ***loss*** is the excess of the adjusted basis of the property over the amount you realize.

Basis. Your cost or purchase price of property is usually its basis for figuring gain or loss from its sale or other disposition. However, if you got the property by gift, inheritance, or in some way other than by buying it, you must use a basis other than its cost.

Adjusted basis. Your original cost or other basis plus certain additions, and minus certain deductions (such as depreciation and casualty losses) is the adjusted basis of your property. Chapter 6 discusses basis of assets. In determining gain or loss, the cost of transferring property to a new owner, such as selling expenses, is added to your adjusted basis.

Amount realized. The amount you realize from a sale or exchange is the total of all money you receive plus the ***fair market value*** of all property or services you receive. The amount you realize also includes any of your liabilities that were assumed by the buyer and liabilities to which the property you traded is subject, such as real estate taxes or a mortgage.

Fair market value. This is the price at which the property would change hands between a willing buyer and a willing seller when both have reasonable knowledge of all the necessary facts and neither is required to buy or sell. If parties with adverse interests place a value on property in an arm's length transaction, that is strong evidence of fair market value. If there is a stated price for services, this price is treated as their fair market value, unless there is contrary evidence.

Example. In your business you used a building that cost you $70,000. You made certain permanent improvements at a cost of $20,000 and deducted depreciation totaling $10,000. You sold the building for $100,000 cash, plus property having a fair market value of $20,000. The buyer assumed the accrued real estate taxes of $3,000 and a mortgage of $17,000. The selling expenses were $4,000. Your gain on the sale is figured as follows:

Amount realized:		
Cash	$100,000	
Property received (fair market value)	20,000	
Real estate taxes (assumed by buyer)	3,000	
Mortgage (assumed by buyer)	17,000	
Amount realized		$140,000
Adjusted basis:		
Cost of building	$ 70,000	
Improvements	20,000	
Total	$ 90,000	
Less: Depreciation	10,000	
Adjusted basis	80,000	
Plus: Selling expenses	4,000	84,000
Gain on sale		$ 56,000

Amount recognized. The amount you realize from a sale or exchange of business or investment property may not always be recognized (included in income) for tax purposes. Generally, gains from the sale, exchange, or other disposition of property must be included in gross income, and losses from these transactions are deductible. However, there are exceptions to this rule under *Nontaxable Exchanges.*

Nontaxable Exchanges

Certain exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even if you realize a gain or loss on the exchange, it will not be recognized (included in income) for tax purposes until you sell or dispose of the property you receive.

Like-kind exchanges. The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be nontaxable, a like-kind exchange must meet ***all six*** of the following conditions:

One. The property must be business or investment property. Both the property you trade and the property you receive must be held by you for business or investment purposes. Neither may be used for personal purposes, such as your home or family car.

Two. The property must not be property held for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for investment or property held for productive use in your trade or business. Machinery, buildings, land, trucks, and rented houses are examples of property that might qualify. Inventories, raw materials, accounts receivable, other current assets, and real estate that dealers hold for sale to customers are examples of property that would not qualify.

Three. There must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like property. For example, the trade of an apartment house for a store building that you rent out, or a panel truck for a pickup truck, is a like-kind exchange. An exchange of personal property for real property does not qualify as a like-kind exchange. An exchange of city property for farm property, or improved property for unimproved property is a like-kind exchange.

The exchange of real estate you own for a real estate lease that runs 30 years or more is a like-kind exchange. The exchange of a remainder interest for a remainder interest, both used in a trade or business, is a like-kind exchange. However, not all exchanges of interests in real property qualify. For example, the exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange.

An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of single property for single property. Whether you have engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange.

If the like-kind exchange includes the receipt of money or unlike property, you may have a taxable gain (see *Partially nontaxable exchange,* later).

Four. The property must be tangible property. These rules for like-kind, nontaxable exchanges do not apply to exchanges of stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of debt or interest, or the exchange of partnership interests. However, you may have a nontaxable exchange of corporate stock. See *Exchanges for Corporate Stocks,* later in this chapter.

Five. The property must meet the identification requirement. The property to be received must be identified on or before the date that is 45 days after the date you transfer the property given in the exchange. The identification requirement may be met by designating the property to be received in the contract between the parties. Also, the identification requirement will be satisfied if the contract specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties.

For example, if the executed contract for transfer of property provides that you will transfer real estate to Mary Brown in exchange for property A if zoning changes are approved, and for property B if the zoning change is not approved, the identification requirement is satisfied.

Six. The exchange must meet the completed transaction requirement. The property must be received on or before the earlier of:

- The 180th day after the date on which you transfer the property given up in the exchange, or
- The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

Binding contract. Rules five and six above apply to:

- Transfers made after July 18, 1984, if the property to be received in the exchange is identified in a binding contract in effect on June 13, 1984 and at all times thereafter before the transfer, and
- Transfers made before July 19, 1984, if the property to be received in the exchange is not received before 1989.

For any transfers before July 19, 1984, which you treat as part of a like-kind exchange, the period for assessing any tax attributable to that exchange will not expire before 1990.

Like-kind exchanges between related parties. New rules limit whether certain exchanges made between related parties after July 10, 1989, are nontaxable. These rules affect both direct and indirect exchanges. As with other like-kind exchanges, when related parties exchange like-kind property, no gain or loss is recognized (included in income). Under the new rules, however, if either party disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment. The 2 year holding period begins on the date of the last transfer of property which was part of the like-kind exchange. The gain or loss must then be recognized as of the date of disposition of the property.

Related parties. Under these rules, a related party includes a member of your family (spouse, brother, sister, parent, child, etc.) and a corporation in which you have more than 50% ownership. For more information on related parties, see *Loss not deductible,* under *Sales and Exchanges Between Related Parties* in Publication 544.

Exceptions to the related party rules. The following kinds of property dispositions are also excluded from the new limits on nontaxable like-kind exchanges between related parties:

1) Dispositions due to the death of either related person,
2) Involuntary conversions, or
3) Exchanges or dispositions if it is established to the satisfaction of the IRS that the main purpose is not the avoidance of federal income tax.

For more information, see *Like-kind exchanges between related parties* under *Nontaxable Exchanges* in Publication 544.

Special rule for foreign real property exchanges. For transfers after July 10, 1989, real property located in the United States and real property located outside of the United States are no longer considered like-kind property. Therefore, if you exchange foreign real property for property located in the U.S., the exchange cannot be treated as a nontaxable like-kind exchange.

Exception. This rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like-kind under the rules for replacing condemned property to postpone gain on the condemnation. See *Gain or Loss from Condemnations,* under *Involuntary Conversions (Exchanges),* in Publication 544.

Partially nontaxable exchange. If, in addition to like property, you receive money or unlike property in a like-kind exchange, you have a partially nontaxable exchange. You are taxed on the part of the gain you realize, but only to the extent of the money and the fair market value of the unlike property you receive.

To figure the amount of taxable gain, first determine the fair market value of any unlike property you receive and add it to the amount of any money you receive. The total is the maximum amount of gain that can be taxed. Next, figure the amount of gain on the whole exchange, as discussed earlier under *Gain or Loss from Sales and Exchanges.* Your taxable gain is the lesser of these two amounts. A loss is never deductible in a nontaxable exchange, even though you receive unlike property or cash.

Example. You exchange real estate held for investment, having an adjusted basis of $8,000, for other real estate that you want to hold for investment. The real estate you receive has a fair market value of $10,000. You also receive $1,000 in cash. Although the total gain realized on the transaction is $3,000, only $1,000 (cash) is recognized and included in your income.

Assumption of liabilities. If the other party to a nontaxable exchange assumes any of your liabilities, or you transfer property subject to a liability, you will be treated as if you received cash in the amount of the liability. If, in the preceding example, the property you give up is subject to a $3,000 mortgage, figure the gain realized and the amount of gain to be taxed as follows:

Fair market value of like property received	$10,000
Cash	1,000
Mortgage assumed on property given up	3,000
Total consideration received	$14,000
Less: Adjusted basis of property you transferred	8,000
Realized gain	$ 6,000

The realized gain is taxed only up to $4,000, the sum of the money ($1,000) and the mortgage ($3,000). To figure the basis of the new property, see Chapter 6.

If you pay money. If, in addition to giving up like property, you pay money in a like-kind exchange, you still have no taxable gain or deductible loss.

Example. Bill Smith trades an old cab for a new one. The new cab costs $10,800. He is allowed $2,000 for the old cab, and pays $8,800 cash. He has no taxable gain or deductible loss on the transaction, regardless of the adjusted basis of his old cab. If Bill had sold the old cab to a third party for $2,000 and purchased a new one, he would have had a recognized gain or loss on the sale of his old cab equal to the difference between the amount realized and the adjusted basis of the old cab.

If you give up unlike property. If, in addition to like property, you give up unlike property, you must recognize gain or loss only on the unlike property you give up. The gain or loss is equal to the difference between the fair market value of the unlike property and that property's adjusted basis.

Example. You exchange stock and real estate that you held for investment for real estate that you also intend to hold for investment. The stock you transfer has a fair market value of $1,000 and an adjusted basis of $4,000. The real estate you exchange has a fair market value of $19,000 and an adjusted basis of $15,000. The real estate you receive has a fair market value of $20,000. You do not have a taxable gain or deductible loss on the exchange of the real estate because it qualifies as a nontaxable exchange. However, you must recognize a $3,000 loss on the stock because the stock is unlike property.

Sale and purchase. If you sell property and buy similar property in two mutually dependent transactions, you may be required to treat the sale and purchase as a single nontaxable exchange. See the example earlier in this chapter, under *Nontaxable exchange.*

Multiple-party transactions. The like-kind nontaxable exchange rules also apply to property exchanges that involve ***three- and four-party transactions.*** Any part of these multiple-party transactions can qualify as a nontaxable like-kind exchange if it meets all six of the conditions described earlier, including the identification and completed transaction requirements. Also, if the nontaxable exchange includes the receipt of money or unlike property (in addition to like property), any gain realized will be taxed to the extent of the money plus the fair market value of the unlike property.

Receipt of title from third party. If you received property in a like-kind exchange and the other party who transfers property to you does not give you the title but a third party does, you may still treat this transaction as a nontaxable exchange.

New Form 8824. Beginning in 1990, if you exchange property in a like-kind transaction, you must file Form 8824, *Like-kind Exchanges,* in addition to Schedule D (Form 1040) or Form 4797.

Transfers between spouses. No gain or loss is recognized (included in income) on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if incident to divorce. This rule does not apply if the recipient-spouse is a nonresident alien. It also does not apply to a transfer in trust if the adjusted basis of the property is less than the amount of the liabilities assumed and liabilities on the property. For more information, see *No gain or loss* under *Property Settlements* in Publication 504, *Tax Information for Divorced or Separated Individuals.*

Exchanges for Corporate Stocks

In certain cases, exchanges for corporate stock are nontaxable. The rules for these exchanges are given below.

A corporation's own stock. A corporation may dispose of its own stock, including treasury stock, without having a taxable gain or loss. For options acquired or lapsed after July 18, 1984, there is no recognized gain or loss by a corporation as to any lapse or acquisition of an option to buy or sell its own stock, including treasury stock.

Stock for stock of the same corporation. You may exchange common stock for common stock in the same corporation, or preferred stock for preferred stock in the same corporation, without having a taxable gain or loss.

Convertible stocks and bonds. If you convert bonds into stock, or preferred stock into common stock, you will not have a taxable gain or loss. For this rule to apply, the stock you receive must be in the same corporation as the bond or preferred stock you convert. The conversion also must be made according to the terms of the bond or preferred stock certificate.

Property for stock. If you transfer property to a corporation in exchange for stock or securities in that corporation, and immediately afterwards you are in control of the corporation, the exchange is usually nontaxable. This rule applies both to individual investors and to groups of investors who transfer property to a corporation.

However, if the property exchanged includes depreciable property, you may be taxed on ordinary gain because of depreciation. See *Depreciation Recapture on Personal Property* and *Depreciation Recapture on Real Property* in Chapter 23.

Control of a corporation. To be in control of the corporation, you or your group of investors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock.

Example. You and Bill Jones transfer property having a basis of $100,000 to a corporation for stock having a fair market value of $300,000. This represents only 75% of each class of stock of that corporation. The other 25% already had been issued to someone else. You and Bill recognize a taxable gain of $200,000 on the transaction.

Services rendered. The term ***property*** does not include services rendered or to be rendered to the issuing corporation. Therefore, stock received for services is income to the recipient.

Example. You transfer property worth $35,000 and render services valued at $3,000 to a corporation in exchange for stock valued at $38,000. Right after the exchange you own 85% of the outstanding stock. No gain is included in income on the exchange of property; however, you will recognize ordinary income of $3,000 as payment for the services you rendered.

Property of relatively small value. The term ***property*** does not include property of a relatively small value when it is compared to the value of stock and securities already owned or to be received for services by the transferor, if the main purpose of the transfer is to qualify the nonrecognition of gain or loss by other transferors.

Property transferred will not be considered to be of relatively small value if the fair market value of the property transferred is at least 10% of the fair market value of the stock and securities already owned or to be received for services by such person.

Stock received in disproportion to property transferred. If a group of investors exchange property for corporate stock, each investor does not have to receive stock in proportion to his or her interest in the property transferred. If a disproportionate transfer takes place, it will be treated for tax purposes in accordance with its true nature. It may be treated as if the stock and securities had been received in proportion and then some of it was used to make gifts, pay compensation for services, or satisfy the transferor's obligations.

Money or other property. If, in a nontaxable exchange of property for corporate stock, you also receive money or property other than stock, you may have a taxable gain. You are taxed only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring gain in this situation generally follow those for a *Partially nontaxable exchange,* discussed earlier under *Nontaxable exchanges.* Therefore, no loss is recognized.

Liabilities. If the corporation assumes your liabilities, or the property is taken subject to a liability, the transfer generally will not be treated as if you received money or other property. There are two exceptions to this treatment:

1) If the liabilities the corporation assumes are more than your adjusted basis in the property you exchange, gain is recognized up to the amount of the excess. However, if the liabilities assumed would give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
2) If there is no good business reason for the corporation to assume your liabilities, or if

your main purpose in the exchange is to avoid federal income tax, the assumption will be treated as if you received the money in the amount of the liabilities.

Example. You transfer property to a corporation for stock. You also receive $10,000 cash in the exchange. Your adjusted basis in the property you transfer is $20,000. The stock you receive has a fair market value of $16,000. The corporation also assumes a mortgage of $5,000 on the property. The gain realized is as follows:

Stock received, fair market value	$16,000
Cash received	10,000
Liability assumed by corporation	5,000
Total received	$31,000
Less: Adjusted basis of property transferred	20,000
Realized gain	$11,000

The gain recognized is limited to $10,000, the amount of the cash received.

22. Gains and Losses: Capital or Ordinary

If you have a taxable gain or a deductible loss from a transaction, it may be a capital gain or loss or it may be an ordinary gain or loss, depending on the circumstances. In some situations, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss.

When you sell or exchange a capital asset, your gain or loss is a capital gain or loss. It will be a long-term gain or loss if you owned the asset for more than one year. It will be a short-term gain or loss if you owned the asset one year or less.

It is important that you properly classify everything you sell or exchange as:

1) A capital asset,
2) A noncapital asset, or
3) An asset that may be treated as either capital or noncapital, depending on the circumstances. This category includes some assets used in your trade or business, and involuntarily converted assets held in a trade or business or a transaction entered into for profit. These assets are referred to as "section 1231 property."

Sale of a business. If you sell a business that you operate as a ***sole proprietorship,*** see Chapter 27. If you sell your interest in a ***partnership,*** see Chapter 28. If you sell your interest in a ***corporation,*** see Chapter 29.

How To Classify Assets

For the most part, everything you own and use for personal purposes or investment is a capital asset.

Some examples of capital assets are:

- Stocks or bonds;
- A home owned and occupied by you and your family;
- Timber grown on your home property or investment property, even if casual sales of the timber are made;
- Household furnishings;
- A car used for pleasure or commuting;
- Coin or stamp collections;
- Gems and jewelry;
- Gold, silver, or any other metal.

Capital asset defined. Everything you own is a capital asset ***except:***

1) Property held mainly for sale to customers or property that will physically become a part of the merchandise that is for sale to customers,
2) Accounts or notes receivable acquired in the ordinary course of your trade or business, or for services rendered as an employee, or from the sale of any properties described in (1),
3) Depreciable property used in your trade or business (even though fully depreciated),
4) Real property used in your trade or business,
5) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property—
    a) Created by your personal efforts, or
    b) A letter, memorandum, or similar property, prepared or produced for you, or
    c) Acquired from a person who created the property, or for whom the property was prepared, under circumstances entitling you to his or her basis (for example, by gift), and
6) U.S. Government publications that you got from the government free or for less than the normal sales price or that you acquired under circumstances entitling you to the basis of someone who got the publications free or for less than normal sales price, if you sell, exchange, or contribute the publication.

Personal (nonbusiness) property. Gain from a sale or exchange of a capital asset is a capital gain. A ***loss*** from the sale or exchange of such property is not deductible unless it results from a personal casualty loss.

Property held mainly for sale to customers. Whether property is held mainly for sale to customers is a question of fact to be judged in each case. Among the factors to be considered are:

1) The purpose for which the property is acquired,
2) The development of the property between the time it was acquired and sold,
3) The number and frequency of sales, and
4) The time the property is held before it is sold.

Example. You are in the business of developing and selling restaurant businesses. You are constantly acquiring new sites, developing them and then selling the businesses. After you've completed construction of a restaurant and prior to operation, you sell it. Because the businesses are property you hold mainly for sale to customers in the ordinary course of your business, the businesses are not capital assets. Gain or loss from the sale of the businesses is ordinary gain or loss. The result would be the same if you had incorporated the restaurants and sold the stock of the corporations.

Sales and exchanges between related parties. If a gain is recognized on the sale or exchange of property, including a leasehold or a patent application, that is depreciable property in the hands of the party who receives it, the gain may be ordinary income. The gain is ordinary income if the transaction is either directly or indirectly between:

1) A person and that person's controlled entity or entities (discussed below),
2) A taxpayer and any trust in which the taxpayer (or his or her spouse) is a beneficiary, unless the beneficiary's interest in the trust is a remote contingent interest, that is, the value of the interest computed actuarially is 5% or less of the value of the trust property,
3) An employer and any person related to the employer under rules (1) and (2), and
4) A welfare benefit fund (within the meaning of section 419(e)) that is controlled directly or indirectly by persons referred to in rule (3).

A controlled entity is:

1) A corporation in which ***more than 50%*** of the value of all outstanding stock, or a partnership in which ***more than 50%*** of the capital interest or profits interest, is owned, directly or indirectly, by or for one person.
2) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.
3) Two corporations that are members of the same controlled group.
4) Two S corporations, if the same persons own more than 50% in value of the outstanding stock of each corporation.
5) Two corporations, one of which is an S corporation, if the same person owns more than 50% in value of the outstanding stock of each corporation.

Determining control. For purposes of the above rules, use the following discussion to determine if you control an entity.

1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries,
2) An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family, including only brothers and sisters (either whole or half), spouse, and
3) Stock ***constructively owned*** by a person under rule (1), for applying rules (1) and (2), is treated as actually owned by that person. But stock constructively owned by an individual under rule (2) will not be treated as owned by the individual for applying rule (2) to make another person the constructive owner of that stock.

Loss not deductible. No deduction is allowable for losses from sales or exchanges of property (other than corporate liquidations) directly or indirectly between the related taxpayers listed under *Related persons* in Chapter 4. For information regarding losses from sales or exchanges of property between partners and partnerships, see *Partner's Dealings with the Partnership* in Chapter 28.

Property received from a related party. If, in a sale or exchange, you receive property from a related party who had a loss on the exchange that was not allowable and you sell or exchange the property at a gain, you recognize the gain only to the extent that it is more than the loss not allowed to the transferor. This rule applies only if you are the original transferee.

Example. You sell stock with a cost basis of $10,000 to your brother for $7,600. Your loss of $2,400 is not deductible. Later he sells the same stock for $10,500, thus realizing a gain of $2,900 ($10,500 —$7,600). His reportable gain is only $500, the excess gain over the $2,400 loss not allowed to you.

Transferring a patent. If you transfer a patent for value, see *Inventions* later in this chapter for a discussion of transfers to certain related persons that will not qualify for capital gain treatment.

Stocks, stock rights, and bonds. Stocks, stock rights, and bonds, including stock received as a dividend are capital assets. However, see *Losses on Small Business Stock (Section 1244)*, later in this chapter.

Dividends on stock sold. If stock is sold, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee of the dividend check) must report the dividend. Even if the purchase price of the stock goes up because of the amount of the anticipated dividend, the owner of record must report such dividend.

Bonds sold between interest dates. When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of sale. The seller must report this amount as interest income. The purchaser may treat this amount as a capital investment and deduct it from the next interest payment as a return of capital, but must report the total payment as taxable interest and show the accrued interest as an adjustment (or subtraction).

Non-dealer equity options. Gain or loss from the sale or exchange of a listed equity option traded by a non-dealer, or traded by dealers as part of their investment activity instead of dealer activity, is a gain or loss from the sale or exchange of a capital asset.

Gain or loss from the sale or exchange of a non-listed option to buy or sell property that is not a capital asset in your hands, or would not be if you acquired it, is ordinary gain or loss, such as certain options to purchase real estate in the ordinary course of a trade or business. Under certain circumstances, this may be treated as a capital gain or loss.

Option not exercised. If you do not exercise an option to buy or sell, and you have a loss, the option is treated as having been sold or exchanged on the date that it expired. Your loss is either a capital or an ordinary loss, as already explained.

The capital asset treatment does not apply:

1) To a gain from the sale or exchange of a non-listed option, if the gain from the sale of the property underlying the option would be ordinary income, or
2) To a dealer in non-listed options, if the option is part of the dealer's inventory.

Granting an option on stocks. If you grant (write) an option on stocks or securities and it is not exercised, the amount you receive (if you are not in the business of granting options) is a short-term capital gain.

Gain or loss from the closing or expiration of an option that is not a section 1256 contract, but that is a capital asset in your hands, is reported on Schedule D (Form 1040).

If a purchased option expired, enter the expiration date in column (c), and write "Expired" in column (d).

If an option granted (written) expired, enter the expiration date in column (b), and write "Expired" in column (e).

If the option is exercised, you add the option payment to other amounts you receive to compute the amount you realize on the sale of the property. The classification of your gain or loss is then determined by the type of property you sold.

A cash settlement option is treated as an option to buy or sell property. A cash settlement option is any option that on exercise settles in, or could be settled in, cash or property other than the underlying property.

A section 1256 contract option on exercise is treated as an option to buy or sell property. Generally, a section 1256 contract is any regulated futures contract, any foreign currency contract, any nonequity option, and any dealer equity option. A section 1256 contract that you acquire and that remains open at the end of the tax year is generally treated as sold at its fair market value on the last business day of the tax year.

See Publication 550, *Investment Income and Expenses*, for a discussion of section 1256 contracts and options.

Holding period. Your holding period for property acquired under an option to buy begins on the day after the property was acquired, not the day after the option was acquired.

Commodity futures. A commodity future is a contract for the sale or purchase of some fixed amount of a commodity at a future date for a fixed price. The contracts are treated as either:

Hedges to insure against unfavorable price changes in a commodity bought or sold in the course of business, or

Capital investments.

Gains and losses on hedging contracts for a commodity purchased in the ordinary course of a trade or business to insure the price of, or an adequate supply of the commodity for use in the business are treated as ordinary gains and losses. Hedging does not include any transaction entered into by or for a syndicate.

Straddles. Straddles are options on securities and are not discussed in this publication. For more information see Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*, and *Straddles* in Publication 550.

Inventions. An invention is usually a capital asset in the hands of the inventor whether or not a patent or patent application has been obtained. The inventor is the individual whose efforts created the property and who would qualify as the original and first inventor or joint inventor.

Transfer. If you transfer (sell or exchange) a patent you may be able to apply a special tax treatment. To be eligible, all of the following requirements must be met:

1) The transfer was other than a gift, inheritance, or device,
2) You transferred all substantial rights in the patent or an undivided interest in all such rights,
3) The invention is acquired before it is tested and operated successfully under operating conditions,
4) It must not be transferred to or acquired from a related person (described later), and
5) It must not be acquired from the inventor under a contract requiring the transfer.

All ***substantial rights*** to patent property mean all rights that are of value when they are transferred. The right to prohibit sublicensing or subassignment of rights, or the keeping of a security interest (such as a lien), or a reservation calling for forfeiture for nonperformance, are not treated as substantial rights for these rules and may be kept by you as the holder of the patent.

Special tax treatment. If you are the inventor, or an individual who acquired all the substantial rights to the patent property, and you transfer all the substantial rights, or an undivided interest in all of these rights, the transfer will be treated as a sale or exchange of a long-term capital asset. This applies even if you have not held the patent property for more than one year and the payments received are made:

1) Periodically during the transferee's use of the property, or
2) Contingent on the productivity, use, or disposition of the transferee's rights in the property.

Related persons. The special tax treatment does not apply if the transfer is either directly or indirectly between you and a related person as defined under *Related persons*, in Chapter 4, with the following changes:

1) Members of your family include your spouse, ancestors, and lineal descendants, but not your brothers or sisters (or half-brothers or half-sisters).
2) An individual and a corporation are considered related parties if the individual owns, directly or indirectly, 25% or more in value of the outstanding stock of the corporation.
3) A partnership and a partner, if the partner owns, directly or indirectly, 25% or more of the capital or profits of the partnership (other than an interest in the partnership).
4) Two partnerships, if the same persons directly or indirectly own 25% or more of the capital or profits of each.

If you come within the definition of a related taxpayer independent of family status, the brother-sister exception does not apply. Thus, a transfer between a brother and a sister, one of whom is the beneficiary and the other the fiduciary of a trust, is a transfer between related parties. The brother-sister exception does not apply because the trust relationship is independent of the family status.

Trade secrets (technical "know-how"). Trade secrets are generally eligible for capital gains treatment on their sale or exchange. A transfer of a trade secret is a sale or exchange, if the transfer includes all substantial rights to the trade secret. The substantial rights that must be transferred are the right to use the trade secret in perpetuity or until it becomes public knowledge and no longer protectable under the laws of the country where the transferee operates, and the exclusive right to prevent further disclosure.

Copyrights. Literary, musical, or artistic compositions, or similar property are not treated as capital assets if your personal efforts created them, or if you acquired the property in such a way that all or part of your basis in the property is determined by reference to a person whose personal efforts created it (for example, if you received the property as a gift). The sale of such property, whether or not it is copyrighted, results in ordinary income and is generally reported on Form 4797, *Sales of Business Property*.

If you acquire such property or a copyright to it in any other way, the amounts you receive for granting the exclusive use or right to exploit the work throughout the life of the copyright are treated as being received from the sale of property. It does not matter if the payment is a fixed amount or a percentage of receipts from the sale, performance, exhibition, or publication of the copyrighted work, or an amount based on the number of copies sold, performances given, or exhibitions made.

Nor does it matter if it is paid over the same period as that covering the grantee's use of the copyrighted work. If the property was used in your trade or business, the gain or loss is a section 1231 gain or loss.

Letters, memorandums. Letters, memorandums, and similar property (such as drafts of speeches, recordings, transcripts, manuscripts, drawings, or photographs) are not treated as capital assets if your personal efforts created them or they were prepared or produced for you. Also, this property is not a capital asset if your basis in the property is determined by reference to the person who created the property or the person for whom it was prepared. For this purpose, letters and memorandums addressed to you are considered prepared for you. If letters or memorandums are prepared by persons under your administrative control, they are considered prepared for you whether or not you review them.

Gold, silver, stamps, coins, gems, etc. These items are capital assets except when they are held for sale by a dealer. Any gain or loss on their sale or trade generally is a capital gain or loss. If you are a dealer the sale is ordinary income reportable on Schedule C (Form 1040).

Contract for services. A contract for services is not a capital asset. If you assign or sell such a contract, and the assignee or purchaser is only entitled to compensation for services under the terms of the contract for its remaining life, the amount you receive is ordinary income.

Transfer of a franchise, trademark, or trade name. A franchise includes an agreement that gives one of the parties the right to distribute, sell, or provide goods, services, or facilities, within a specified area.

If the amounts you pay or incur to buy a franchise, trademark, or trade name are not contingent, and the transferor does not retain any significant power, right, or continuing interest, then your payments are for the purchase of a capital asset and must be capitalized.

The transfer of a franchise, trademark, or trade name will not receive capital gain or loss treatment if you kept any significant power, right, or continuing interest in the franchise, trademark, or trade name. A transfer includes the renewal of a franchise, trademark, or trade name.

Significant power. Significant power, right, or continuing interest in a franchise, trademark, or trade name includes, but is not limited to, the following rights in the transferred interest:

1) A right to disapprove any assignment of the interest, or any part of it.
2) A right to end the agreement at will.
3) A right to set standards of quality for products used or sold, or for services provided, and for the equipment and facilities used to promote such products or services.
4) A right to make the recipient sell or advertise only your products or services.
5) A right to make the recipient buy most supplies and equipment from you.
6) The right to get payments based on the productivity, use, or disposition of the item of interest transferred if such payments are a substantial part of the transfer agreement.

Amounts you receive or accrue for a franchise, trademark, or trade name that are contingent on the productivity, use or disposition of these assets are not treated as amounts received from a sale of a capital asset.

Goodwill

Goodwill is a capital asset that may or may not exist within a business. If it does exist, then when the business is sold, the seller can receive capital gain treatment on the part of the sales price that is for goodwill. The buyer cannot deduct any of the amount paid for goodwill because it is a capital asset with an unknown useful life and it cannot be depreciated or amortized. The amount the buyer pays for goodwill becomes its basis to the business.

Goodwill is also used to represent ***going concern value,*** and includes every positive advantage that a firm gets in doing its business. It is the total of all those indefinable qualities that bring customers to a business, such as the right to have the business at a particular location under a trade name or trademark, any special knowledge or know-how, the number and quality of customers, or any other similar elements of value in the business as a going concern.

If you ***buy a business,*** you must figure your basis in goodwill by allocating the consideration paid first among the other assets acquired. Likewise, if you ***sell a business***, you must figure your gain or loss by allocating the sales price received first among assets other than goodwill. The sales price paid or received must be reduced first by the amount of cash, demand deposits, and similar accounts transferred by the seller. You allocate to the other assets an amount of the sales price in proportion to and not in excess of their fair market value on the purchase date in the following order:

1) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency.
2) All other assets, both tangible and intangible, except goodwill.

The remainder of the sales price, after making the above-listed allocations, is allocated to goodwill. See *Goodwill* in Publication 544 for more information.

Foreclosure, Repossession, or Abandonment

If an owner (borrower) does not make the payments due on a loan secured by property, the lender (mortgagee or creditor) may foreclose on the mortgage, or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which the owner may realize gain or loss. This is true even if the property is voluntarily conveyed to the lender.

The owner who stops making payments on the secured loan may abandon the property. The abandonment is treated as a disposition from which the owner may realize ordinary income or loss.

Form 1099–A. If you are the owner of property that is secured by a loan and the lender acquires an interest in it, the lender may send you Form 1099–A, *Information Return for Acquisition or Abandonment of Secured Property,* or an equivalent statement. You may also get a Form 1099–A from the lender if you abandoned the secured property and the lender had reason to know that the property had been abandoned. The lender must give you a copy of this Form by January 31, 1991.

For more information see *Foreclosure, Repossession, or Abandonment,* in Publication 544.

Timber

If you sell standing timber you held as investment property, it is a capital asset and is treated as a sale of a capital asset. Gain or loss is reported on Schedule D. If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on the sale is ordinary income or loss reported in the gross receipts/sales and cost of goods sold items of your return. Special rules apply, however, if you owned the timber more than one year and you either choose to treat timber cutting as a sale or exchange, or enter into a cutting contract discussed below. Depletion on timber is discussed under *Timber* in Chapter 13.

Christmas trees. Evergreen trees, such as Christmas trees, that are more than 6 years old, severed from their roots and sold for ornamental purposes, are included in the term "timber" and qualify for both rules, discussed below.

Timber cutting treated as a sale or exchange. Under the general rule, the cutting of timber results in no gain or loss. It is not until the sale or exchange that gain or loss is realized. But if you owned, or had a contractual right to cut timber, you may choose to treat the cutting of timber as a sale or exchange in the year it is cut. Even though the cut timber is not actually sold or exchanged, you report your gain or loss on the cutting for the year the timber is cut. Any later sale results in ordinary income or loss. See *Example,* below.

To have your timber qualify for this treatment, you must:

1) Have owned, or held a contractual right to cut, the timber for a period of more than one year before the timber was cut,
2) Cut the timber for sale or for use in your trade or business, and
3) Elect to treat the cutting of the timber as a sale or exchange of property used in a trade or business (regardless of whether the timber is includible in inventory or held primarily for sale to customers).

Election. You make your election on your return for the year in which the cutting takes place by including in income the gain or loss on the cutting, and including a computation of your gain or loss. You do not have to make the election in the first year you cut timber. You may choose to make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

Once you have made the election, it remains in effect unless you can show undue hardship. Except for the special rule below, you must obtain the consent of the IRS to revoke your election. A revocation prevents you from again making this election except with the consent of IRS.

Special revocation. A special rule for any election you made for a tax year beginning before 1987 allows you to revoke the election for any tax year ending after 1986 without the consent of IRS. You can revoke the election by attaching a statement to the tax return for the tax year that the revocation is to be effective. If you make this special revocation, which can be made only once, you can still make a new election without the consent of the IRS. Any further revocation or later election will require the consent of IRS. The statement must provide:

1) Your name, address, and identification number,
2) That the revocation of election is being made to treat cutting of timber as a sale or exchange under IRC section 631(a),
3) That the revocation is being made under section 311(d) of PL 99-514,
4) The year the revocation is effective and timber to which applicable, and
5) That you are entitled to make the revocation under section 311(d) of PL99-514 and temporary regulations section 5(h).5(a)(3)(i).

Gain or loss. Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its fair market value on the first day of your tax year in which it is cut.

Example. In April 1990, you have owned for more than 12 months 4,000 MBF (1,000 board feet) of standing timber. It has an adjusted basis for depletion of $40 per MBF. You are a calendar year taxpayer. On January 1, 1990, the timber had a fair market value of $120 per MBF. It was cut in April for sale. On your 1990 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report as a gain the difference between the fair market value and your adjusted basis for depletion. This amount is reported on Form 4797, along with your other section 1231 gains and losses to figure whether it is treated as long-term capital gain or as an ordinary gain. You figure your gain as follows:

Fair market value of timber on January 1, 1990	$480,000
Less: Adjusted basis for depletion	160,000
Section 1231 gain	$320,000

The fair market value becomes your basis for the timber cut, and a later sale of the cut timber, including any by-product or tree tops, results in ordinary income or loss.

Cutting contract. If you own standing timber and dispose of it under a cutting contract, you must treat the disposal as a sale or exchange if you held the timber for more than one year before its disposal and you retain an economic interest in it.

The difference between the amount realized from the disposal of the timber and the timber's adjusted basis for depletion is treated as gain or loss on its sale. This amount must be included on Form 4797 along with your other section 1231 gains and losses to figure whether it is treated as capital or ordinary gain or loss.

Date of disposal. This is the date the timber is cut. However, if you receive payment under the contract before the timber is cut, you may choose to treat the date of payment as the date of disposal.

Owner. This election is effective only for the purpose of figuring the holding period of the timber. It has no effect on the time for reporting gain or loss. The election is made by a statement attached to the tax return filed by the due date (including extensions) for the year the payment is received. The statement shall identify the advance payments subject to the election and the contract under which they were made. Any person who owns an interest in the timber, including a sublessor and the holder of a contract to cut timber, is the owner.

Economic interest. This means that you have acquired an interest in standing timber by investment and get, by any form of legal relationship, income from cutting that timber, to get a return of your capital investment.

Example. You own standing timber that you held for more than one year. It has an adjusted basis for depletion of $20 per MBF. You had no other gains or losses during the year. If you enter into a contract with a buyer that gives him a right to cut and remove the timber for $40 per MBF, you will have a section 1231 gain of $20 per MBF on the disposal.

Tree stumps. Tree stumps are a capital asset if they are on land held by an investor who is not in the timber or stump business, as a buyer, seller, or processor. Gain from the sale of stumps sold in one lot by such a holder is taxed as a capital gain. However, tree stumps held by timber operators, after the saleable standing timber was cut and removed from the land, are considered by-products. Gain from the sale of stumps by lot or on a tonnage basis by such operators is taxed as ordinary income.

Coal and Iron Ore

If you own coal (including lignite) or iron ore mined in the United States for more than one year and dispose of it under a contract in which you keep an economic interest in the coal or iron ore, figure any resulting gain as follows. Take the difference between the amount realized from disposal of the coal or iron ore and its adjusted basis for depletion (increased by certain expenditures not allowed as deductions for the tax year). This amount is included on Form 4797 along with your other section 1231 gains and losses.

You are considered an ***owner*** if you own or sublet an economic interest in the coal or iron ore in place. If the tax on any capital gains from the disposition of coal or iron ore is less than the maximum rate for ordinary income, you are not entitled to the allowance for percentage depletion for the coal or iron ore. In addition, this special gain or loss treatment does not apply to income realized by an owner who is a co-adventurer, partner, or principal in the mining of coal or iron ore. See Chapter 13.

The expenses of making and administering the contract under which the coal or iron ore was disposed of and the expenses of preserving the economic interest kept under the contract are not allowed as deductions in figuring taxable income. Rather, their total along with the adjusted depletion basis is deducted from the amount received to determine the gain. If the total of the expense of making and administering the contract plus the adjusted depletion basis is more than the amount received, the result is a loss. The date of disposal is treated as the date the coal or iron ore is mined.

Special rule. The above treatment does not apply to you if you dispose of the iron ore or coal directly or indirectly to:

1) A related taxpayer (defined under *Related persons* in Chapter 4), whose relationship to you would result in the disallowance of a loss,
2) A partnership if you are a partner who owns directly or indirectly more than 50% of the capital or profits interests in the partnership, or between two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests, or
3) An individual, trust, estate, partnership, association, company, or corporation owned or controlled directly or indirectly by the same interests that own or control your business.

Losses on Small Business Stock (Section 1244)

An individual (not including a trust or estate) can deduct, as an ordinary loss, a loss on the sale, exchange, or worthlessness of small business stock. This ordinary loss is reported on line 10, Part II of Form 4797. The gain on this stock, however, is a capital gain if the stock is a capital asset in your hands and is reported on Schedule D (Form 1040).

Ordinary loss. The ordinary loss that you can deduct on this stock is limited to $50,000. On a joint return, the limit is $100,000 even if only one spouse has this type of loss. Thus, if your loss is $110,000 and your spouse has this type of loss, you may deduct $100,000 on a joint return. The excess of $10,000 is a capital loss.

No offset of gains and losses. Do not offset the gains against the losses that are within the ordinary loss limits, even if the transactions are in stock of the same corporation.

The stock must be issued to the individual taking the loss. The ordinary loss deduction is available only to the original owner of this stock. To claim a deductible loss on stock issued to your partnership, you must have been a partner when the stock was issued and remain so until the time of the loss. You add your distributive share of the partnership loss to any individual loss you may have on the stock before applying the deduction limitation.

Stock distributed by the partnership. If the partnership distributes the stock to the partners, the partners will not be able to treat a stock loss as an ordinary loss.

For more information about the treatment of losses on small business stock, see Publication 550.

Figuring Capital Gains and Losses

If you have a gain or loss from the disposition of a capital asset, it is a capital gain or loss. Likewise, you may have a capital gain from the disposition of a noncapital asset, if it is section 1231 property (discussed later). However, a net section 1231 loss is an ordinary loss, and not a capital loss. Gain or loss on the disposition of a capital asset that is treated as if it were a noncapital asset is ordinary gain or loss.

Long- and short-term. The treatment of capital gains and losses depends on how long you own the asset before you sell or exchange it. The time you own an asset before disposing of it is the holding period.

If you hold a capital asset one year or less, the gain or loss from its disposition is short term. If you hold a capital asset longer than one year, the gain or loss from its disposition is long term.

These distinctions are essential to correctly arrive at your net capital gain or loss. Capital losses are allowed in full against capital gains plus up to $3,000 of ordinary income.

Inherited property. If you inherit property, your basis in that property is generally its fair market value at the date of the decedent's death or the later alternate valuation date if the estate qualifies and elects to use alternate valuation. If no federal estate tax return was filed, use the appraised value (fair market value) at the date of death for state inheritance or transmission taxes. You cannot use an alternate valuation date.

Gifts to decedent. The basis in certain appreciated property that you acquire may be the decedent's adjusted basis in the property immediately before death rather than its fair market value. This applies only if you or your spouse had given the appreciated property as a gift to the decedent during the one-year period ending on the date of death and the date of death was after 1981. Appreciated property is any property whose fair market value on the day it was given to the decedent is more than its adjusted basis.

Long-term gain or loss. If you inherit property and your basis for it is determined under one of the valuation methods just described, your ***gain or loss on any later disposition*** of the property is treated as a long-term capital gain or loss. You are considered to have held the property for more than one year even if you dispose of it within one year after the decedent's death.

Holding period. To figure if you held property more than one year, start counting on the day following the day you acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you dispose of the property is part of your holding period.

Example. If you bought an asset on June 19, 1990, you should start counting on June 20, 1990. If you sell the asset on June 19, 1991, your holding period is not more than one year, but if you sell it on June 20, 1991, your holding period is more than one year.

Installment sale. The gain from an installment sale of a capital asset qualifying for a long-term capital gain treatment in the year of sale will continue to be long term in later tax years. If it is short term in the year of the sale, it will continue to be short term when payments are received in later tax years.

Nontaxable exchanges. If you acquire an asset in exchange for another asset, your basis for the new asset is figured, in whole or in part, by your basis in the old property; the holding period of the new property includes the holding period of the old property. That is, it begins on the same day as your holding period for the old property.

Corporate liquidation. The holding period for property you receive in a liquidation generally starts on the day after you receive it if gain or loss is recognized. However, in a one calendar month liquidation in which your basis in the property is figured in whole or in part, using the basis of the stock you gave up in the transaction, the holding period of the property includes the holding period of the stock.

Gifts. If you receive a gift of property and your basis in it is figured using the donor's basis, your holding period includes the donor's holding period. See *Property Received as a Gift,* in Publication 551.

Real property. To figure how long you have held real property, start counting on the day after you received title to it or, if earlier, the day after you took possession of it and assumed the burdens and privileges of ownership.

However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Repossession. If you sell real property but keep a security interest in it and then later repossess it, your holding period for a later sale includes the period you held the property before the original sale, as well as the period after the repossession. Your holding period does not include the time between the original sale and the repossession. That is, it does not include the period during which the first buyer held the property.

Net Gain or Loss

The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

First, combine your short-term capital gains and losses. Do this by adding up all your short-term capital gains. Then add up all your short-term capital losses. Subtract one total from the other. The result is your ***net short-term capital gain or loss.***

Next, follow the same steps to merge together your long-term capital gains and losses. The result is your ***net long-term capital gain or loss.***

Finally, merge your net short-term capital gain or loss with your net long-term capital gain or loss. The result is your ***total net capital gain or loss.***

Example. During the tax year, you have the following transactions:

Long-term capital gains	$ 5,400	
Long-term capital losses	(1,750)	
Net long-term capital gain		$ 3,650
Short-term capital gains	$ 2,600	
Short-term capital losses	(3,790)	
Net short-term capital loss		(1,190)
Net capital gain		$ 2,460

Total net capital gain. If you have a total net capital gain, the gain is taxable.

Total net capital loss. If you have a total net capital loss, the loss is deductible. But there are limits on how much of the loss you may deduct, and when you may deduct it. See *Treatment of Capital Losses,* below.

Treatment of Capital Losses

If you have a net capital loss, you must deduct it even if you do not have ordinary income to offset the loss. The yearly limit on the amount of the capital loss you are required to deduct is the lower of:

- $3,000 ($1,500 if you are married and file a separate return), or
- Your net capital loss on line 18 of Schedule D (Form 1040).

Capital loss carryover. If your net capital loss is more than the yearly limit on capital loss deductions, carry over the excess to later years until it is completely used up. When you carry over a loss, it retains its original character as either long term or short term. A short-term loss that you carry over to the next tax year is added to short-term losses that occur in that year. A long-term loss that you carry over to the next year is added to long-term losses that occur in that year.

For information on how to figure your carryover, see *Capital loss carryover* under *Schedule D* in Chapter 26.

Corporations. A corporation, other than an S corporation, may deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has a total net capital loss, the loss cannot be deducted in the current tax year. It must be carried to other tax years and deducted from capital gains that occur in those years.

A net capital loss is first carried back 3 years. It is deducted from any net capital gain that occurred in that year. If the loss is not completely used up, it is carried forward 1 year (2 years back) and then 1 more year (1 year back). If it is still not used up, it is carried over to future tax years, 1 year at a time, for up to 5 years. When a net capital loss is carried to another tax year, it is treated as a short-term loss. It does not retain its original identity as long term or short term.

Example. In 1990 a corporation has a net short-term capital gain of $3,000 and a net long-term capital loss of $9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of $6,000. This $6,000 is treated as a short-term loss when carried back or forward.

In 1987, the corporation had a net short-term capital gain of $8,000 and a net long-term capital gain of $5,000. The $6,000 short-term loss that is carried back from 1990 is subtracted first from the net short-term gain. This results in a net capital gain for 1987 of $7,000, consisting of a net short-term capital gain of $2,000 ($8,000 minus $6,000) and a net long-term capital gain of $5,000.

Rules for carryover and carryback. When carrying a capital loss from one year to another, the following rules apply:

In figuring this year's net capital loss, you cannot use any capital loss carried from another year. In other words, you may only carry capital losses to years that would otherwise have a net capital gain.

If capital losses from 2 or more years are carried to the same year, the loss from the earliest year is deducted first. When that loss is completely used up, the loss from the next earliest year is deducted, and so on.

A capital loss carried from another year cannot be used to produce or increase a net operating loss in the year to which it is carried.

Foreign expropriation losses. A corporation may not carry back foreign expropriation capital losses. However, these losses may be carried over for up to 10 future tax years. They will be treated as short-term capital losses in each year to which they are carried.

Refunds. When you carry back a capital loss to an earlier tax year, you must refigure your tax for that year. If you find your corrected tax is less than you originally owed, you may apply for a refund. File Form 1120X, *Amended U.S. Corporation Income Tax Return.*

Section 1231 Property

Property used in a trade or business or held for the production of rents or royalties and held more than one year is known as section 1231 property and is subject to section 1231 treatment. These rules also apply to any other property held more than one year that is subject to an involuntary conversion. In a disposition of depreciable property, you first figure the ordinary income part of the gain as discussed in Chapter 23. Any remaining gain is included in the section 1231 computation.

Property used in your trade or business. Property you use in your trade or business includes real property and depreciable personal property, but not property you hold for sale to customers.

Real property. This includes all interests, such as easements, leaseholds, water rights, etc., that are recognized as real property under applicable state law.

Depreciable property. Most assets used to carry on your trade or business, for which you expect to get back most or all of your investment through depreciation deductions are depreciable assets.

Gains and losses. Combine all gains and losses from the sales or dispositions of section 1231 property for the tax year. If the section 1231 gains exceed the section 1231 losses, you have a net section 1231 gain. If the section 1231 gains are more than the section 1231 losses, then these gains and losses must be treated as long-term capital gains or long-term capital losses. An excess of section 1231 losses over section 1231 gains results in a net section 1231 loss. If the section 1231 losses equal or exceed the section 1231 gains, then you treat each item as an ordinary gain or loss. See the Form 4797 discussion in Chapter 26. Involuntary conversions are discussed in Chapter 25.

Recapture of net ordinary losses. A net section 1231 gain is treated as ordinary income to the extent the gain does not exceed nonrecaptured net section 1231 losses taken in prior years. ***Nonrecaptured losses*** are net section 1231 losses deducted for your five most recent tax years that have not yet been applied (recaptured) against any net section 1231 gains in a tax year beginning after 1984. Your losses are considered recaptured beginning with the earliest year subject to recapture.

Example. Ashley, Inc., a graphic arts company, is a calendar year corporation. In 1987 Ashley had a net section 1231 loss of $8,000. For tax years 1989 and 1990, the company has net section 1231 gains of $5,250 and $4,600, respectively. In figuring taxable income for 1989, Ashley treated its net section 1231 gain of $5,250 as ordinary income by recapturing $5,250 of its $8,000 net section 1231 loss. Then, in 1990, Ashley applies the remaining net section 1231 loss, $2,750 ($8,000 minus $5,250) against its net section 1231 gain of $4,600. The company reports $2,750 as ordinary income and also reports $1,850 ($4,600 minus $2,750) as long-term capital gain.

Long-term capital gain or ordinary income? If you did not have any prior year net section 1231 losses or they were recaptured in an earlier year, treat the amount of your net section 1231 gain for 1990 as long-term capital gain.

If you had such losses and they were not recaptured, your net section 1231 gain is treated as ordinary income up to the amount of the nonrecaptured losses. If the gain exceeds the losses, the excess gain is a long-term capital gain.

Net section 1231 loss. A net section 1231 loss for 1990 is treated as an ordinary loss.

Casualty and thefts. If your recognized losses from involuntary conversions arising from fire, storm, shipwreck, other casualty, or theft exceed your recognized gains from such conversions, they are not included in figuring your net section 1231 gains or losses to figure recapture of net section 1231 losses.

23. Gain on Disposition of Depreciable Property

If you dispose of depreciable property at a gain, you may have to treat all or part of the gain as ordinary income. This chapter discusses the rules for figuring the amount of the gain on depreciable property that is ordinary income. (Losses are not subject to the rules discussed in this chapter.) It also includes information on: section 1231 property, depreciation recapture, like-kind exchanges, and involuntary conversions.

Records. You must keep permanent records of the facts necessary to figure the amount of depreciation that was allowed or allowable on your depreciable property to figure any gain that must be reported as ordinary income. This includes the date of acquisition, cost or other basis, depreciation, and all other adjustments that affect basis.

Your records must also indicate, on any property you got in a nontaxable exchange or as a gift:

1) Whether the adjusted basis was figured using depreciation or amortization you claimed on other property, and
2) Whether the adjusted basis was figured using depreciation or amortization another person claimed.

Depreciation Recapture on Personal Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property. See *Treatment of Gain,* later.

Section 1245 property. Section 1245 property includes any property that is or has been subject to an allowance for depreciation and that is:

1) Personal property (both tangible and intangible),
2) An elevator or an escalator (placed in service before 1987),
3) Real property (not included in (4)), to the extent its adjusted basis has been reduced by amortization deductions for certified pollution control facilities, expenditures to remove architectural and transportation barriers to the handicapped and elderly, reforestation expenditures, on-the-job training and child-care facilities, or for which a section 179 deduction was taken, or
4) A special purpose structure or storage facility. This includes storage facilities (other than buildings and their structural components) used in connection with the distribution of petroleum or any primary product of petroleum. It is also any other depreciable tangible property, ***except*** a building or its structural components, that is or has been an integral part of certain business activities, a research facility used in connection with these activities, or a storage facility used in connection with these activities. These activities are manufacturing, production, extraction, or the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services.

Building and its structural components. A building and its structural components do ***not*** include a structure that is essentially an item of machinery or equipment. Also, they do not include a structure that houses property used as an integral part of an activity, if the use of the structure is so closely related to the use of the property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. The fact that the structure is specially designed to withstand the stress and other demands of the property and cannot be economically used for other purposes indicate that it is closely related to the use of the property it houses. Thus, structures such as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples are not treated as buildings.

Storage facility. A storage facility is a facility used mainly for the bulk storage of fungible commodities. To be fungible, a commodity must be such that any one part may be used in place of another. Bulk storage means the storage of a commodity in a large mass before it is used. Stored materials that vary in composition, size and weight are not fungible. One part cannot be used in place of another part and the materials cannot be estimated and replaced by simple reference to weight, measure, and number.

Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage.The storage of different grades and forms of aluminum scrap is not bulk storage of fungible commodities.

Treatment of Gain

The amount of gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is limited to the ***lower*** of the amounts listed below:

1) The recomputed basis of the property minus the adjusted basis of the property, or
2) The amount realized from the sale minus the adjusted basis of the property.

For any other disposition of section 1245 property, ordinary income is measured by the amount the fair market value exceeds the adjusted basis of the property. See *Other Dispositions*, later.

Recomputed basis. Recomputed basis of your section 1245 property is the total of its adjusted basis plus depreciation and amortization (allowed or allowable) included in the adjusted basis. This includes depreciation and amortization adjustments on:

Property you exchanged for, or converted to, the present property in a like-kind exchange or involuntary conversion,

Property owned by someone before you, and

Property you presently own.

Property received in an exchange or conversion. If you receive property in a like-kind exchange or involuntary conversion, the recomputed basis of that property includes a depreciation or amortization adjustment taken on the old property you exchanged or converted. This is reduced by any gain you recognized on the exchange or conversion of the old property.

Depreciation. Depreciation is the amount allowed or allowable for section 1245 property for cost recovery of property used in a trade or business or held for the production of income.

Amortization. Amortization includes the section 179 deduction claimed (discussed later), and the deductions for: removal of certain barriers for persons with disabilities and the elderly, child-care facilities or on-the-job training facilities, pollution control facilities, reforestation expenditures, and certain expenditures for certified historic structures.

Investment credit. In figuring the deductions affecting the recomputed basis of section 1245 property, you should also include any basis adjustment that was made for investment credit claimed on the property. See *Investment credit*, later.

Example 1. In February 1988 you purchased and placed in service for 100% use in your business a light-duty truck (5-year property) with an adjusted basis of $10,000. You file your return on a calendar year. Your MACRS deductions for this truck were $2,000 in 1988 and $3,200 in 1989. You did not take the section 179 deduction on the truck. The MACRS deduction in 1990, the year of sale, is $960 (1/2 of $1,920). You sell the truck in May 1990 for $7,000. Your adjusted basis is $3,840 ($10,000 minus $6,160). Your recomputed basis is $10,000 ($3,840 plus $6,160). The amount you treat as ordinary income is the lower of the following:

Recomputed basis ($10,000) minus adjusted basis ($3,840) or $6,160, or

Amount realized ($7,000) minus adjusted basis ($3,840) or $3,160.

The lower of these two amounts, $3,160, is the amount of gain treated as ordinary income.

Example 2. On January 2, 1981, you bought a machine for $9,000. You claimed $600 depreciation on it each year and sold it for $8,000 on July 3, 1990. Your adjusted basis on the date of sale was $3,300 ($9,000 less $5,700 (the $600 depreciation for each of the years 1981 through 1989 and $300 for 1990)). Your recomputed basis is $9,000 (your total depreciation deductions plus your adjusted basis). The amount you treat as ordinary income is the lower of the following:

Recomputed basis ($9,000) minus adjusted basis ($3,300) or $5,700, or

Amount realized ($8,000) minus adjusted basis ($3,300) or $4,700.

The lower of these two amounts, $4,700, is the amount of gain treated as ordinary income. Because the gain ($4,700) is less than the total depreciation ($5,700), the entire gain is included as ordinary income.

Section 1231 gain. Any gain that is more than the ordinary income part is a section 1231 gain. As such, it is subject to the rule on nonrecaptured net section 1231 losses for determining whether all or part of the section 1231 gain is treated as long-term capital gain or ordinary income. See *Section 1231 Property* in Chapter 22.

Depreciation on property other than personal property. You must take into account depreciation during periods when the property was not used as an integral part of an activity or did not constitute a research or storage facility, as described earlier.

For example, if depreciation deductions taken on certain storage facilities amounted to $10,000, of which $6,000 is from the periods before their use in connection with a prescribed business activity, you must use the entire $10,000 in determining ordinary income because of depreciation.

Depreciation allowed or allowable. The greater of the depreciation allowed or allowable is generally the amount to use in figuring the part of gain to report as ordinary income. If in prior years you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been allowable under another proper method. If you did not take any deduction at all for depreciation your adjustments to basis for depreciation allowable are figured by using the straight line method of depreciation.

This treatment applies only when figuring what part of gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

Section 179 deduction. Amounts deducted under section 179 are recovered as ordinary income to the extent of any gain on a sale or disposition. The section 179 deduction is treated as a deduction for depreciation and is included in the recomputed basis. See *Section 179 Deduction* in Chapter 12.

Investment credit. On a disposition of section 1245 property or section 1250 property (discussed later), the reduction in basis by part or all of the investment credit claimed on the property is considered a deduction allowed for depreciation.

If a disposition results in the recapture of investment credit on property whose depreciable basis has been reduced, the basis of the property immediately before the disposition resulting in the recapture is increased by part or all of the recapture amount. This amount is any increase in tax that must be paid plus any adjustment to investment credit carrybacks or carryforwards. For more information, see Chapter 31.

Section 1245 property and other property in same disposition. A sale or other disposition may involve a combination of section 1245 property and other property. To figure the gain or loss on each item, the total amount realized must be allocated among the section 1245 property and the other property in proportion to each item's fair market value. If a buyer and seller have adverse interests, their arm's length agreement setting values for the items will establish the allocation. Special allocation rules apply to the sale of a group of assets that can be a trade or business. See *Allocating the Basis* in Publication 551, *Basis of Assets*. Losses cannot be used to offset gains to report a combined gain or loss for section 1245 property.

Multiple asset accounts. In figuring ordinary income because of depreciation, you may treat any number of units of section 1245 property in a single depreciation account as one item if the total ordinary income because of depreciation figured by using this method is not less than it would be if depreciation on each unit were figured separately.

Example. In one transaction you sold 50 machines, 25 trucks, and certain other property that was not section 1245 property. All of the depreciation was recorded in a single depreciation account. After dividing the total received among the various assets sold, you figured that each unit of section 1245 property was sold at a gain. You may figure the ordinary income because of depreciation as if the 50 machines and 25 trucks were one item.

However, if 5 of the trucks had been sold at a loss, only the 50 machines and 20 of the trucks could be treated as one item in determining the ordinary income because of depreciation.

Normal retirement. The normal retirement of section 1245 property in multiple asset accounts does not require recognition of ordinary income because of depreciation if your method of accounting for asset retirements does not require recognition of that gain.

Depreciation Recapture on Real Property

A gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. See *Additional Depreciation*, later.

Section 1250 property. Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not and has never been section 1245 property or section 1245 recovery property. It also includes leased property (such as a building) to which the lessee has made improvements that are subject to an allowance for depreciation, and the cost of acquiring a lease.

If, because of a change in its use, section 1250 property becomes section 1245 property in the hands of a taxpayer, it may never again be treated as section 1250 property by that taxpayer.

The deductions taken under either ***ACRS or MACRS*** are treated as ordinary income under section 1245 except for such deductions taken on the following properties, which are treated as section 1250 property:

1) 15–year, 18–year, or 19–year real property and low-income housing that is residential rental property,
2) 15–year, 18–year, or 19–year real property and low-income housing that is used mostly outside of the United States,
3) 15–year, 18–year, or 19–year real property and low-income housing on which the alternate ACRS method of depreciation is taken, and
4) Low-income property.

For more information on 15–year, 18–year, and 19–year property, get Publication 534, *Depreciation.*

The ordinary income rules for gains on section 1250 property dispositions ***do not*** apply to an item if:

1) You figure depreciation on the property using the straight line method or any other method as long as that method does not result in depreciation that is more than the amount that is figured by the straight line method, and you have held the property more than a year,
2) You realize a loss on the sale, exchange, or involuntary conversion of the property,
3) You dispose of low-income rental property that you held for 16⅔ years or more (for low-income rental housing on which the special 60–month depreciation for rehabilitation expenditures was allowed, the 16⅔ years started when the rehabilitated property was placed in service),
4) You chose the alternate ACRS method for the types of 15–, 18–, or 19–year real property covered by the section 1250 rules, or
5) You dispose of residential rental property or nonresidential real property that was depreciated under the MACRS method. Additional depreciation is not treated as ordinary income on the disposition of residential rental property and nonresidential real property because these properties are now depreciated using the straight line method.

Gain treated as ordinary income. To find what part of the gain is treated as ordinary income follow these steps:

1) In a sale, exchange, or involuntary conversion of the property, figure the excess of the amount realized over the adjusted basis of the property (in any other disposition of the property, figure the excess of fair market value over adjusted basis),
2) Figure the additional depreciation for the periods after 1975, and
3) Multiply the smaller of (1) or (2) by the applicable percentage (discussed later).

   If any gain is left after following this procedure (that is, if (1) is more than (2)), then:

4) Figure the additional depreciation for the periods after 1969 and before 1976,
5) Multiply the smaller of the remaining gain ((1) less (2)) or (4) by the applicable percentage (as discussed later), and
6) Add the results from (3) and (5) to arrive at the gain that is to be treated as ordinary income. See *Special rule for corporations,* later, for additional income corporations may have to report.

Part III, Form 4797 is used to figure the ordinary income part of section 1250 gain.

Additional Depreciation

If you hold section 1250 property longer than one year, the additional depreciation is the excess of actual depreciation adjustments over the depreciation figured for the same period using the straight line method. Treat any basis reduction for investment credit as a deduction for depreciation. (See *Investment credit,* earlier.) If you hold section 1250 property for one year or less, all the depreciation is additional depreciation.

The ***additional depreciation for 15–, 18–, or 19–year real property*** is the excess of the amount allowed or allowable over that based on straight line depreciation for the recovery period you actually used for the property.

You will have additional depreciation if you use the regular ACRS method, the declining balance method, the sum of the years-digits method, the units-of-production method, any other method of rapid depreciation, or if you elect amortization. You will not have additional depreciation from the amortization of: certified pollution control facilities, on-the-job training and child-care facilities, expenditures to remove architectural and transportation barriers for persons with disabilities and the elderly, or certain rehabilitation expenditures for certain historic structures.

Special rule for corporations. Corporations, other than S corporations, have an additional amount to recognize as ordinary income on the sale or other disposition of section 1250 property. The additional amount treated as ordinary income on the sale of section 1250 property is 20% of the excess of the amount that would have been ordinary income if the property was section 1245 property, or section 1245 recovery property, over the amount treated as ordinary income under section 1250. Report this additional ordinary income on line 26(f) of Form 4797, Part III in the same property column used for the amount recaptured under section 1250.

Depreciation taken by other taxpayers or on other property. Additional depreciation includes all depreciation adjustments in the basis of section 1250 property, whether allowed or allowable to you or another person (as for carryover basis).

Example. Larry Johnson gives his son section 1250 property on which he took $2,000 in depreciation deductions, of which $500 is additional depreciation. Immediately after the gift, the son's adjusted basis in the property is the same as his father's and reflects the $500 additional depreciation. On January 1 of the next year, after taking depreciation deductions of $1,000 on the property, of which $200 is additional depreciation, the son sells the property. At the time of sale, the additional depreciation is $700 ($500 allowed the father plus $200 allowed the son).

Depreciation allowed or allowable. The greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in figuring its adjusted basis in your hands) is generally the amount to use in figuring the part of gain to be reported as ordinary income. If you can show that the deduction allowed for any tax year was less than the amount allowable, the smaller figure will be the depreciation adjustment for figuring additional depreciation.

Retired or demolished property. The adjustments reflected in adjusted basis generally do not include deductions for depreciation on retired or demolished parts of section 1250 property, unless these deductions are reflected in the basis of replacement property that is section 1250 property.

Example. If a wing of a building is totally destroyed by fire, the depreciation adjustments figured in the adjusted basis of the building after the wing is destroyed, do not include any deductions for depreciation on the destroyed wing unless the wing is replaced and the adjustments for depreciation on the destroyed wing are reflected in the basis of the replacement property.

Useful life and salvage value. The useful life and salvage value you use to figure the amount that would have been the depreciation if you had used the straight line method are the same as you used under the depreciation method you actually used. Salvage value is not used for either the ACRS or MACRS methods of depreciation. If you did not use a useful life under the depreciation method actually used (such as with the units-of-production method), or if you did not take salvage value into account (such as with the declining balance method), the useful life or salvage value for figuring what would have been the straight line depreciation is the useful life and salvage value you would have used under the straight line method.

Property held by lessee. If a lessee makes a leasehold improvement, the lease period for figuring what would have been the straight line depreciation adjustments and for figuring the additional depreciation includes all renewal periods. This extension cannot extend the period taken into account to a period which exceeds the remaining useful life of the improvement. This same rule applies to the cost of acquiring a lease.

Renewal period. This means any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee. However, the inclusion of renewal periods cannot extend the lease by more than two-thirds of the period that was the basis on which the actual depreciation adjustments were allowed.

Rehabilitation expenditures. A part of the special 60–month depreciation adjustment allowed for rehabilitation expenditures incurred in connection with low-income rental housing is additional depreciation. After 1986, the special 60–month treatment of expenditures is no longer available unless the expenditures were incurred under a binding contract, or if rehabilitation began before 1987.

If the property is held one year or less after the expenses are incurred, the entire special depreciation adjustment is treated as additional depreciation. If the property is held more than one year after the expenses are incurred, the additional depreciation is the excess of the special depreciation adjustments from the rehabilitation expenditures over the adjustments that would have resulted had the straight line method and the normal useful life and salvage value been used.

Applicable Percentage

To figure the amount taxable as ordinary income because of additional depreciation, for real property you disposed of, you may have to use one or two applicable percentages depending on whether the property is nonresidential real property, residential real property, or low-income housing (discussed in Publication 544). The applicable percentages that must be applied to these types of real property are as follows.

Nonresidential real property. For real property, which is neither residential real property nor low-income housing, the applicable percentage is 100% for periods after 1969. For real property first depreciated before 1970, the applicable percentage is zero. No ordinary income will result on its disposition because of additional depreciation before 1970.

Residential real property. For residential real property (85% or more of the gross income is from dwelling units), other than low-income housing, the applicable percentage for periods after 1975 is 100%. For residential rental property (80% or more of the gross rental income is from dwelling units), the applicable percentage for periods after 1969 and before 1976 is 100% minus 1% for each full month the property was held in excess of 100 months. When this property has been held for at least 16⅔ years, the applicable percentage is zero. No ordinary income because of additional depreciation will result on its disposition. The applicable percentage for periods before 1970 is zero. No ordinary income will result on its disposition because of additional depreciation before 1970.

Foreclosure. If section 1250 property is disposed of because of foreclosure or similar proceedings, the monthly percentage reduction of the additional depreciation is figured as if you disposed of the property on the starting date of the proceedings.

Holding period. To figure the applicable percentage, when it is less than 100%, the holding period for property acquired generally starts on the day after it is acquired.

Constructed, reconstructed, or erected property. For property you constructed, reconstructed, or erected, the holding period starts on the first day of the month in which it is placed in service in a trade or business, in the production of income, or in a personal activity.

Section 1250 property acquired by gift or received in a tax-free exchange. For section 1250 property acquired by gift or in a tax-free exchange, the basis of which is figured by reference to the basis in the hands of the transferor, the holding period, for the purpose of the applicable percentage, includes the holding period of the transferor.

If, however, the adjusted basis of the property in the hands of the transferee just after the transaction is more than its adjusted basis to the transferor just before the transaction, the holding period of the excess is figured as if it were a separate improvement.

Property With Two or More Elements

If section 1250 property has more than one separate element, the gain to be reported as ordinary income is the sum of the ordinary income figured for each element. For more information, see *Property With Two or More Elements* in Publication 544.

Installment Sales

A gain from the disposition of depreciable personal property or real property must be reported under the installment method, described in Chapter 24, unless you elect not to have this method apply.

Any recapture of depreciation, including the section 179 deduction, is taxable as ordinary income under section 1245 or 1250 in the year of sale up to the amount of the gain, even if no payments are received in that year. If the gain is more than the depreciation recapture income, report the remainder of the gain using the rules of the installment method. For this purpose, add the recapture income to the property's adjusted basis.

If you dispose of ***more than one asset*** in a single transaction, you must separately figure the gain on each asset so that it may be properly reported. To do this, allocate the selling price and the payments you receive in the year of sale to each asset. Any depreciation recapture income must be reported in the year of sale up to the amount of gain for each asset before capital gain treatment is allowed on any remaining gain.

For more information, see Publication 537, *Installment Sales.*

Other Dispositions

If you make a ***gift*** of depreciable personal property or real property, you are not required to report income on the transaction. However, if the person who receives it (donee) sells or otherwise disposes of the property and this subsequent disposition is subject to recapture, the donee must take into account the depreciation deducted in figuring the gain to be reported as ordinary income.

For depreciable real property on which the applicable percentage is less than 100%, depending on how long the property was held, the donee must take into account the donor's holding period to figure the applicable percentage. Under *Depreciation Recapture on Real Property,* earlier, see *Applicable Percentage,* and its discussion *Holding period.*

Disposition part gift and part sale or exchange. If you transfer depreciable personal property or real property for less than its fair market value, the transaction is considered to be partly a gift and partly a sale or exchange and you have a gain because the amount realized is more than your adjusted basis, you must report ordinary income (up to the amount of gain) to recapture depreciation, as discussed in this chapter. If the depreciation is more than the gain, the balance of your depreciation is carried over to the transferee, to be taken into account on any later disposition of the property. See also, *Gift to charitable organization,* next.

Gift to charitable organization. If your gift is to a charitable organization, the amount of your charitable contribution of property must be reduced by ordinary income and short-term capital gain that would result had you sold the property at its fair market value at the time of the contribution. Also, you may have to reduce the amount of your charitable contribution of property by the long-term capital gain that would result if you sold the property at its fair market value at the time of the contribution. The fair market value of depreciable real or personal property given to a charitable organization must always be reduced by the potential ordinary gain because of depreciation.

See Publication 526, *Charitable Contributions.*

Bargain sale to charitable organization. A bargain sale is a sale or exchange of property to a charitable organization for less than its fair market value. It results in a transaction that is partly a sale or exchange and partly a charitable contribution. A special computation must be made to figure: 1) the gain from the part of the transaction that is a sale, and 2) the amount of any deductible charitable contribution. The adjusted basis of the property must be divided between the part sold and the part given to charity. See *Allocation of basis,* next.

If a deduction for the contribution is not allowable, the transaction is treated as a regular sale. In that case, any gain is figured (without allocation of basis) in the normal manner (selling price less adjusted basis of entire property).

Allocation of basis. If a bargain sale results in a charitable contribution, the adjusted basis of the property must be divided between the part of the property sold and the part of the property given to the charity. This division is made on the basis of the fair market value of each part. See *Allocation of basis* under *Other Dispositions* in Publication 544 for more details about allocating the adjusted basis. For more information about charitable contributions, see Publication 526.

Transfers at Death

When a taxpayer dies, no gain is reported on depreciable personal property or real property that is transferred to his or her estate or beneficiary. For information on the tax liability of a decedent, see Publication 559, *Tax Information for Survivors, Executors, and Administrators.*

However, if the taxpayer disposed of the property while alive and, because of the method of accounting used or for any other reason, the gain from the disposition is reportable by the estate or beneficiary, it must be reported the same way the decedent would have been required to report it if death had not occurred.

Ordinary income due to depreciation must be reported on a transfer from an executor, administrator, or trustee to an heir, beneficiary, or other individual, if the transfer is a sale or exchange on which a gain is realized.

Like-Kind Exchanges and Involuntary Conversions

A like-kind exchange of your property as discussed in Chapter 21, or an involuntary conversion as discussed in Chapter 25, will not result in your having to report ordinary income because of depreciation unless property other than depreciable personal property is received in the transaction.

Other than depreciable personal property. If you receive ***property other than depreciable personal property*** and you include gain as ordinary income because of depreciation, the amount is limited to the ***smaller*** of:

1) The gain on the transaction up to the amount of depreciation deducted, or
2) The gain that must be included in income under the rules for like-kind exchanges or involuntary conversions, ***plus*** the fair market value of property other than depreciable personal property acquired in the transaction.

Example. On January 4, 1990, you bought a new machine for $4,300 cash plus your old machine for which you were allowed a $1,360 trade-in. The old machine cost you $5,000 on January 2, 1986. For 1986 through 1989 you take ACRS deductions of $750, $1,100, $1,050, and $1,050. Even though $3,950 has been deducted under ACRS, the $310 gain ($1,360 trade-in allowance less $1,050 adjusted basis) is not reported because any tax on the gain is postponed and you received only depreciable personal property in the exchange.

Depreciable real property. If you have a gain from a like-kind exchange of your real property as discussed in Chapter 21, or an involuntary conversion as discussed in Chapter 25, the amount to be reported as ordinary income because of additional depreciation is limited to the ***larger*** of:

1) The gain that must be reported under the rules for like-kind exchanges or involuntary conversions, ***plus*** the fair market value of stock purchased as replacement property in acquiring control of a corporation, or
2) The gain you would have had to report as ordinary income because of additional depreciation had the transaction been a cash sale ***less*** the cost (or fair market value of an exchange) of the depreciable real property acquired.

The ordinary income not reported for the year of the disposition is carried over to the depreciable real property acquired in the like-kind exchange or involuntary conversion as additional depreciation from the property disposed of. Further, to figure the applicable percentage of the additional depreciation to be treated as ordinary income, consider the holding period as starting over for the new property.

Example. The state paid you $116,000 when it condemned your depreciable real property for public use. You bought other real property, similar in use to the property condemned, for $110,000 ($15,000 for depreciable real property and $95,000 for land). You also bought stock for $5,000 to get control of a corporation owning property similar in use to the property condemned. You chose to postpone the tax on the gain. If the transaction had been a sale for cash only, under the rules of this chapter, $20,000 would be reportable as ordinary income because of additional depreciation.

The ordinary income to be reported is $6,000, which is the larger of:

1) The gain that would be required to be reported, $1,000 ($116,000 minus $115,000) ***plus*** the fair market value of stock bought as qualified replacement property, $5,000, for a total of $6,000, or
2) The gain you would have had to report as ordinary income because of additional depreciation ($20,000) had this transaction been a cash sale, ***less*** the cost of the depreciable real property bought ($15,000), or $5,000.

Basis of real property acquired in involuntary conversions. If only depreciable real property is acquired to replace depreciable real property in an involuntary conversion in which gain is realized, and tax on the gain is postponed under the rules for involuntary conversions, the basis of the replacement property is its cost less the gain on which tax is postponed. If the replacement consists of more than one piece of depreciable real property, the cost of each piece is reduced by an allocable part of the gain.

However, if the replacement property consists of ***both depreciable real property and other property,*** the basis must be figured as follows:

1) Figure a tentative basis for the depreciable real property by subtracting from its cost the ordinary income because of additional depreciation that is not required to be reported (if more than one piece of depreciable property is acquired, the tentative basis must be allocated to each piece in proportion to its cost),
2) Add the tentative basis figured in (1) to the cost of the other property acquired,
3) Subtract from the total in (2) the excess of gain on which tax is postponed over the ordinary income because of additional depreciation not required to be reported, and
4) Allocate the amount obtained in (3) to each asset in proportion to its cost, as listed in (2).

Example. You receive an insurance payment of $90,000 because of the destruction by fire of depreciable real property (an office building you got in 1980) that had an adjusted basis of $73,000 with additional depreciation of $10,000.

Your realized gain from the involuntary conversion is $17,000. Under the general rules for dispositions of depreciable real property, you would report $10,000 (lesser of $10,000 additional depreciation or your $17,000 gain) as ordinary income because of additional depreciation. You immediately spend the $90,000 for depreciable real property similar in use to the property destroyed. Since you choose to postpone the tax on the gain, no income from the additional depreciation must be reported under the special rule for involuntary conversions, discussed earlier.

The basis of the replacement property is its cost of $90,000 less the $17,000 gain on which tax is postponed, or $73,000. The $10,000 of ordinary income that you would otherwise be required to report is carried over to the replacement property as additional depreciation. The holding period of the newly acquired property includes the period during which you held the converted property.

Depreciable Property and Other Property in One Transaction

If you dispose of both depreciable personal property and other property in a single transaction and realize a gain, you must allocate the amount realized between the two types of property disposed of in proportion to their respective fair market values to figure the part of your gain to be reported as ordinary income because of depreciation. (Special rules may apply to the allocation of the purchase price on the sale of a group of assets, see Publication 551.)

In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the depreciable personal property and other property, any arm's-length agreement between them will establish the allocation.

In a ***like-kind*** exchange or involuntary conversion, if both depreciable personal property and other property are disposed of and both types are also acquired in the transaction, the part realized on the disposition that is allocated to the depreciable personal property is treated as consisting of, first, the fair market value of the depreciable personal property acquired and, second (to the extent of any remaining balance), the fair market value of property other than depreciable personal property acquired. The amount allocated to the other property disposed of is treated as consisting of the fair market value of all property acquired that has not already been taken into account.

If you dispose of depreciable real property and other property in a single transaction, similar rules apply.

Example. A fire destroyed your property having a total fair market value of $50,000 and consisting of machinery worth $30,000 and other property worth $20,000. You received an insurance payment of $40,000 and immediately used it plus $10,000 of your own funds (or a total of $50,000) to buy machinery with a fair market value of $15,000 and other property with a fair market value of $35,000. Assume that your adjusted basis of the machinery was $5,000 and the depreciation on the machinery was $35,000. Assume further that you chose under the rules discussed in Chapter 25 to postpone the tax on your gain arising from the involuntary conversion. You must report $9,000 as ordinary income because of depreciation arising from this transaction, figured as follows—

First. The $40,000 insurance payment must be allocated between the machinery and the other property destroyed, in proportion to the fair market value of each. Therefore, the amount allocated to the machinery is 30,000/50,000 of $40,000, or $24,000, and the amount allocated to the other property is 20,000/50,000 of $40,000, or $16,000. Your gain on the involuntary conversion of the machinery is $24,000 less $5,000 adjusted basis, or $19,000.

Second. The $24,000 allocated to the machinery disposed of is treated as consisting of the $15,000 fair market value of the replacement machinery bought and $9,000 of the fair market value of other property bought in the transaction. All of the $16,000 allocated to the other property disposed of is treated as consisting of the fair market value of the other property that was bought.

Third. You must report as ordinary income, because of depreciation, the smaller of items (1) or (2) listed under *Like-Kind Exchanges and Involuntary Conversions*, and its discussion *Other than depreciable personal property*, earlier. Under item (1) account for your $19,000 gain on the machinery (because it is less than the $35,000 depreciation). Under item (2), do not account for the gain included in income under the rules of Chapter 25 because you chose to postpone the tax on your gain. You must also account for the $9,000 of the fair market value of property other than the depreciable property you bought. This $9,000 is included in the payment for the machinery disposed of. You must report the smaller of the amounts of (1) or (2), $9,000, as ordinary income because of depreciation.

Corporations and Partnerships

Corporations and partnerships figure ordinary income on the disposition of either depreciable personal or depreciable real property in the same way as for individuals described earlier. Although the computations differ for each type of property in arriving at the gain to be reported as ordinary income, once the gain is figured, the treatment of the transaction generally is the same.

For information on depreciable property distributed by corporations see *Distributions of Depreciable Property*, in Publication 542, *Tax Information on Corporations.*

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24. Installment Sales

Important Change for 1990

Installment obligations used as security. If you use an installment obligation to secure any debt, the net proceeds from the debt may be treated as a payment on the installment obligation. This pledge rule applies if the sale price of the property was more than $150,000. It does not apply to the sale of farm property.

An installment sale is a sale of property where one or more payments on the sale is to be received after the close of the tax year. If you finance the buyer's purchase of your property yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. However, you do not have an installment sale if the buyer gives a deed of trust or mortgage to a bank or trust company and then pays you the total selling price.

The buyer's "installment obligation" to make future payments to you might be in the form of a deed of trust, a note, a land contract, a mortgage, or some other evidence of the buyer's indebtedness to you. The rules discussed in this chapter apply regardless of the form of the installment obligation.

You generally report your gain on an installment sale only as you actually receive the payments. It does not matter whether you use the cash or the accrual method of accounting. Each payment you receive on an installment sale usually consists of three parts.

1) Return of your investment (basis),
2) Gain on the sale, and
3) Interest.

Each year that you receive payments, you must include in income the interest part of the payment and the part of the payment that is your gain. Do not include in income the part of the payment that is the return of your basis in the property sold.

For more information on installment sales than is given in this chapter, see Publication 537, *Installment Sales.*

Installment sale form. Each year, including the year of sale, you must report your income from an installment sale on Form 6252, *Installment Sale Income.* Attach this form to your tax return.

Capital assets. If you sell property that is a capital asset, each year you must include the capital gain part of the installment payments in your net gain or loss from the sale or exchange of capital assets. If your gain from an installment sale qualified for long-term capital gains treatment in the year of sale, it will continue to qualify in later tax years when you receive and report the gain from the installment payments. This gain is reported on Schedule D (Form 1040). See Chapter 26.

Business property. Taxable gain from payments you receive each year on an installment sale of business property must be included with certain other gains and losses from business property. Your gain from the sale of business property you held for more than one year may be reported as capital gain in some years and as ordinary gain in other years. If you sell depreciable or amortizable property, you report depreciation recapture income in the year of sale up to the amount of the gain. See Chapter 23.

Dealer sales. Sales of personal property by a dealer or anyone else who regularly sells property on the installment plan cannot be reported on the installment method for federal income tax purposes. This also applies to real property that is held for sale to customers in the ordinary course of the trade or business. However, this does not apply to a sale on the installment plan of any property used or produced in the trade or business of farming.

Death of seller. If an installment obligation is transferred as a result of the death of the seller (or other holder of the obligation), the transfer is not treated as a disposition of the obligation. Unreported gains from the installment obligation are treated as income in respect of a decedent. This means that whoever receives the obligation as a result of the seller's death is taxed on the payments in the same way as the seller would have been if the seller had lived to receive the payments.

However, if the installment obligation is canceled, becomes unenforceable, or is transferred to the buyer, it is treated as a disposition of the obligation. The estate of the seller must figure gain or loss on the disposition. See *Dispositions of Installment Obligations*, later.

Sale at a loss. If your sale results in a loss, you may not use the installment method. If the loss is on an installment sale of business assets, you can deduct it only in the tax year of the sale. You cannot deduct a loss on the sale of property owned for personal use.

Electing out. You can choose not to have the installment sale rules apply to your sale. If you make this choice, you must report your entire gain in the year of sale, even though you will not be paid all of the selling price until later. You then do not have to report any gain from the payments you receive in later years.

If you want to make this choice, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever is appropriate. See *Electing Out* in Publication 537 and the instructions for Schedule D and Form 4797 for more information on choosing not to use the installment method.

When to elect out. You must make the election not to have the installment sale rules apply by the due date, including extensions, for filing your tax return for the year in which the sale takes place. Once made, the election generally cannot be changed. However, you can apply to revoke your election not to use the installment sale rules. A revocation of the election will not be permitted when one of its purposes is the avoidance of federal income tax, or when the tax year in which any payment was received has closed.

Figuring Installment Sale Income

You must allocate the payments you receive each year from an installment sale.

Interest income. If interest is included in the payment, you must separately report all the interest as ordinary income. Interest is generally not included in a down payment. However, you may have to treat a part of each later payment as interest, even if it is not called interest in your agreement with the buyer. See *Unstated Interest*, later.

Gross profit percentage. A certain percentage of each payment (after subtracting out interest) must be reported as gain from the sale. This percentage usually remains the same for each payment you receive. It is called the "gross profit percentage," and is figured by dividing your gross profit from the sale by the contract price.

Example. You sell property at a contract price of $2,000, and your gross profit will be $500. Your gross profit percentage is 25% ($500 divided by $2,000). After subtracting out interest, 25% of each payment, including the down payment, should be reported as your gain from the sale for the tax year the payment is received.

Gross profit. For an installment sale, gross profit is the amount of gain you report on the installment method. It is the total amount of your gain from the sale minus:

1) The amount of gain you must report as ordinary income in the year of sale because of depreciation recapture income (including the section 179 deduction you claimed), and
2) The amount of gain you can postpone or exclude on the sale of your home.

Gain reported in year of sale. For sales of depreciable property figure your depreciation recapture income (including the section 179 deduction recapture) in Part III of Form 4797. Report the recapture income in Part II of Form 4797 as ordinary income in the year of sale. If the amount of your gain equals or is less than the recapture income, you do not have an installment sale. Any gain that exceeds the recapture income can be reported on the installment method if the sale is an installment sale. For more information on the section 179 deduction, see *Section 179 Deduction* in Chapter 12. See Chapter 23 for more information on depreciation recapture.

To figure your gross profit, you must know your basis in the property you sold and the selling price. Add the commissions, any other expenses paid on the sale, and the depreciation recapture income reported in the year of sale to your basis. Then subtract the adjusted basis, as increased, from the selling price to determine gross profit. If the property you sold was your home, also subtract any gain you can postpone or exclude. The result is your gross profit from the sale.

Basis. Basis is a way of measuring your investment in the property you are selling. It is defined and discussed in Chapter 6. For the purpose of figuring gross profit on installment sales, selling expenses and recapture income are always added to adjusted basis. We refer to this total as "installment sale basis" in this chapter.

Selling price. The selling price for an installment sale is the entire cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. It also includes any debt the buyer pays, assumes, or to which the property is subject. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. You cannot go back and refigure the gain you reported in earlier years.

Sale of home. If you sell your home, you may be able to postpone or exclude all or part of the gain on the sale. See Publication 523, *Tax Information on Selling Your Home.* If the sale is an installment sale, any gain you may postpone or exclude is not taken into account. Therefore, you figure your gross profit percentage by including in gross profit only the part of the gain not postponed or excluded.

Contract price. The contract price is the total amount of all the principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. See *Payments,* later.

If the selling price is payable partly in cash, with the remainder secured by a mortgage payable from the buyer to you, then the contract price equals the selling price.

Installment sales to related persons. Special rules apply if you sell property to a related person under the installment method, and that person then sells or otherwise disposes of the property before you receive all the payments from the first sale. Spouses, children, grandchildren, brothers, sisters, and parents are all considered related persons. A partnership or corporation that you have an interest in, or an estate or trust that you have a connection with, can also be considered a related person. For more information, see Publication 537.

Trading property for like-kind (like-kind exchanges). If you exchange property for the same kind of property, you can often postpone reporting part of the gain. See *Like-kind exchanges* under *Nontaxable Exchanges* in Chapter 21 for more information. If the trade includes an installment obligation, the following rules apply:

1) The contract price does not include the fair market value of the like-kind property you receive in the trade.
2) The gross profit is reduced by any gain on the trade that can be postponed.
3) Like-kind property received in the trade is not considered a payment on the installment obligation.

Example. In 1990 George Brown trades personal property with a basis of $40,000 for like-kind property having a fair market value of $20,000. He also receives an installment note for $80,000 in the trade. Under the terms of the note, he is to receive $10,000 (plus interest) in 1991 and the balance of $70,000 (plus interest) in 1992.

George's gross profit is $60,000 (selling price of $100,000 minus the basis of $40,000), and the contract price is $80,000 ($100,000 minus the fair market value of the like-kind property received, $20,000). The gross profit percentage is 75% ($60,000 divided by $80,000). George reports no gain in 1990 because the like-kind property he receives is not treated as a payment for the purpose of figuring gain. He reports $7,500 gain for 1991 (75% of $10,000) and $52,500 gain for 1992 (75% of $70,000).

Payments

You must figure your profit on the payments you receive each year from an installment sale, including the down payment and each later payment of principal on the buyer's debt to you.

In certain situations, you will be considered to have received a payment, even though the buyer does not pay you directly. These situations arise if the buyer takes over or pays off any of your debts, such as a loan, or any of your expenses, such as a sales commission.

Buyer assumes expenses. If the buyer assumes and pays expenses you have in connection with selling your property, it is considered a payment to you in the year of sale. The expenses are included in both the selling price and contract price when figuring the gross profit percentage.

Mortgage assumed. If the buyer assumes (or pays off) your mortgage, or otherwise takes the property subject to it, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is less than your installment sale basis for the property, it is not considered a payment to you. The contract price equals the selling price minus the amount of the mortgage. This difference is all that you will directly collect from the buyer.

Example. You sell property with a basis to you of $19,000 and you have selling expenses of $1,000. The buyer assumes your existing mortgage of $15,000 and, in addition, agrees to pay you a total of $10,000, a cash down payment of $2,000 and $2,000 (plus 12% interest) in each of the next 4 years.

The selling price is $25,000 ($15,000 plus $10,000). The contract price is $10,000 ($25,000 – $15,000 mortgage). Your gross profit is $5,000 ($25,000 – $20,000 (basis plus selling expenses)), and your gross profit percentage is 50% ($5,000 divided by $10,000). Therefore, you must report half of each $2,000 payment you receive as gain from the sale. You must also report all of the interest you receive as income.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis for the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The portion in excess of your basis is treated as a payment in the year of sale. This is in addition to the buyer's other payments.

To figure the contract price, subtract the mortgage from the selling price. This is the total you will actually receive from the buyer. To this amount add the "payment" you are considered to receive (the difference between the mortgage and your installment sale basis). The contract price is then the same as your gross profit from the sale. Therefore, if the mortgage the buyer assumes is equal to or more than your installment sale basis for the property, the gross profit percentage will always be 100%.

Example. The selling price for your property is $9,000. The buyer will pay you $3,000 (plus 12% interest) over the next 3 years, and also assumes an existing mortgage of $6,000. Your basis in the property is $4,400 and you have selling expenses of $600, for an installment sale basis of $5,000. The part of the mortgage that is more than your installment sale basis is $1,000 ($6,000 – $5,000). This amount is included in the contract price and is also treated as a payment you receive in the year of sale. The contract price is $4,000 ($9,000 – $6,000 + $1,000).

Your gross profit on the sale is also $4,000 ($9,000 – $5,000). Therefore, your gross profit percentage is 100%. As the buyer pays you the $3,000, you must report 100% of each payment as gain from the sale. You must also treat the $1,000 difference between the mortgage and your installment sale basis as a payment, and report 100% of it as gain in the year of sale.

Debts. If the buyer pays off any of your debts, such as a loan or back taxes, it may be considered a payment to you in the year of the sale.

If the buyer assumes the debt instead of paying it off, only a part of it may have to be treated as a payment. Compare the amount of the debt to your installment sale basis in the property being sold. If the debt is less than the installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment. This follows the same rules discussed above under *Mortgage assumed.*

However, these rules apply only to two types of debts that the buyer assumes:

1) Those that you acquired in connection with your ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes, and
2) Those that you acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated the same as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is considered a payment to you in the year of the sale.

Payments of property. If you receive property rather than money from the buyer, it is still considered a payment. However, see *Trading property for like-kind property,* earlier. The value of the payment is the property's fair market value on the date you receive it.

Fair market value. This is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its fair market value.

Third-party notes. If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's fair market value. Because the note is itself a payment on your installment sale, any payments you later receive on the note from the third party are not considered payments on your sale. If the fair market value of the note was less than its face value, a part of each payment you receive on it must be reported as ordinary income.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a $5,000, 12% note of a third party. The fair market value of the third-party note at the time of your sale was $3,000. This amount, and not $5,000, is a payment to you in the year of sale. Because the third-party note had a fair market value equal to 60% of its face value ($3,000 divided by $5,000), 60% of each payment of principal you receive on this note is a return of capital. The remaining 40% is ordinary income. The interest you receive is reported in full as ordinary income.

Bonds. A bond or other evidence of indebtedness you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received a payment equal to the bond's fair market value. Accrual basis taxpayers, see section 15A.453–1(e)(2) of the Income Tax Regulations.

Buyer's note. The buyer's note (unless it is payable on demand) is not considered a payment on the sale. Its full face value is included when figuring both selling price and contract price. The payments you receive on the note are reported on the installment method.

Installment obligation used as security (pledge rule). If you use an installment obligation to secure any debt, the net proceeds from the debt are treated as a payment on the installment obligation. This is known as the pledge rule. The pledge rule applies to sales of certain property whose sales price was more than $150,000. It does not apply to the sale of:

Property used or produced in the trade or business of farming, or

Personal use property.

For more information, see *Installment obligation used as security (pledge rule)* under *Payments* in Publication 537.

Guarantees. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered to be a payment.

Deposits. Deposits that you receive before the year of sale should be treated as payments in the year of sale if, under the contract, they become part of the down payment.

Single Sale of Several Assets

If you sell two or more assets in a single sale to one buyer, you may have to allocate the down payment to the assets in proportion to their respective selling prices.

The arm's-length allocation of the selling price and of the payments received in the year of sale will be acceptable if substantiated by all the facts and circumstances. However, an allocation that is not based on the respective selling prices of the assets sold is not acceptable.

If any asset is encumbered by debts that are assumed by the buyer, or the asset is taken subject to a debt and an arm's-length allocation of the down payment or other payments to be received was not made, the down payment and the payments received from installment obligations should be allocated on the basis of the proportionate net fair market values of the assets. The ***net fair market value*** of any asset is its fair market value reduced by any debt on this asset that the buyer assumes or to which the asset is subject.

A sale at a gain of separate and unrelated assets of the same class under a single contract is reported as a single transaction. See Publication 537.

Unstated Interest

Both the buyer and the seller must treat a part of each installment sale payment as interest. For the most part, this interest will be stated in the sales agreement. However, in some situations you may have to treat a certain amount of each payment as interest, even though it is not called interest in your agreement with the buyer. This amount, generally referred to as ***unstated interest,*** reduces the stated selling price of the property and increases the seller's interest income and the buyer's interest expense.

For more information on unstated interest, see Publication 537.

Dispositions of Installment Obligations

If you dispose of an installment obligation (the buyer's note, mortgage, etc.), you will usually have a gain or loss to report. The gain or loss is considered to result from the sale of the property for which the installment obligation was received. If the original installment sale of the property produced ordinary income, the disposition of the obligation will result in ordinary income or loss. If the original sale resulted in a capital gain, the disposition of the obligation will result in a capital gain or loss. See Chapter 22 for more information on capital gains and losses.

Use the following rules to figure your gain or loss from the disposition of an installment obligation.

If you ***sell or exchange the obligation,*** or if you accept less than face value in satisfaction of the obligation, the gain or loss is the difference between your basis in the obligation and the amount you realize.

If you ***dispose of the obligation in any other way,*** the gain or loss is the difference between your basis in the obligation and its fair market value at the time of the disposition.

The cancellation of installment obligations, for example, is a disposition other than by sale or exchange. The gain or loss is the difference between the basis of the obligations and their fair market value at the time of the cancellation.

Basis. Your basis in an installment obligation depends on the amount that has not been paid on the obligation (the unpaid balance) and your gross profit percentage. The amount of profit on the installment sale payments that you have not received from the buyer is determined by multiplying the unpaid balance by the gross profit percentage.

The remainder of the unpaid balance is your basis in the obligation. It represents the part of your basis in the property you sold that you have not already recovered in payments from the buyer.

Example. Several years ago you sold some property on the installment method. The buyer still owes you $10,000 of the selling price. This is the unpaid balance on the buyer's installment obligation to you. Because your gross profit percentage is 60%, $6,000 (60% of $10,000) is the profit still due you on the obligation. The rest of the unpaid balance, $4,000, is your basis in the obligation.

Forgiving part of the buyer's debt. If you reduce the selling price or accept part payment in a later year, and cancel the balance of the buyer's debt on an installment sale, you treat the settlement as a disposition of the installment obligation. You must report the gain, or deduct the loss, in the year of settlement. The gain or loss is the difference between your basis in the obligation and the amount you realize.

If you reduce the selling price but do not cancel the rest of the buyer's debt to you, it is not considered a disposition of the installment obligation. You must refigure the gross profit percentage and apply it to the payments you receive after the reduction.

For more information, see Publication 537.

Repossessions

If the buyer defaults on the contract and you repossess the property, you may have a gain, a loss, or a bad debt. The rules used to figure the gain or loss from repossessions of personal property are different from those used to figure the gain or loss from repossessions of most real property.

A detailed explanation of the tax treatment of repossessions is in Publication 537.

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25. Casualties, Thefts, and Condemnations

When property is damaged or destroyed by hurricane, earthquake, tornado, fire, vandalism, auto accident, flood, etc., such an event is called a ***casualty.*** A casualty may result in a deductible loss on your federal income tax return. If your property is stolen, you may have a deductible ***theft*** loss.

The lawful taking of your property, without your consent, for public use by the federal government, a state government, or a political subdivision is a ***condemnation*** that can result in a gain or a loss.

Casualties, thefts, and condemnations are called ***involuntary conversions.*** For more information on condemnations, see Publication 544, *Sales and Other Dispositions of Assets.*

Gain. If you have a gain from the sale of property under condemnation, or threat of condemnation, or a gain from a casualty or theft, you may postpone paying tax on the gain if you buy qualified replacement property within the specified replacement period, discussed later, under *Postponement of Gain*. If you do not choose to postpone the tax, you must report the gain, as explained in Chapter 26.

Loss. If you have a loss from a condemnation, or threat of condemnation, you may deduct the loss only if the property was business or investment property, or if the loss resulted from a casualty or theft. You may not deduct losses from condemnations of property held for personal use, such as your personal residence. See the discussion under *Form 4684* in Chapter 26 on how to report a casualty loss to business property.

Casualty

A casualty loss must result from an identifiable event that is sudden, unexpected, or unusual. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that is ordinarily unanticipated and unintentional on the part of the one who has the loss. An unusual event is one that is not a day-to-day occurrence and one that is not typical of the activity in which you are engaged.

For information on casualties and thefts of nonbusiness property, see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

Deductible casualty losses. Deductible casualty losses may result from a number of different causes, including:

1) Earthquakes, hurricanes, tornadoes, floods, storms, volcanic eruptions, mine cave-ins, sonic boom, vandalism.
2) Auto or truck accidents, but if your willful negligence or act caused the accident, the loss to your car or truck is not a casualty loss.
3) Fires, but if you set the fire, you cannot deduct the loss resulting from the fire.

Nondeductible losses. Damage from a normal process or from ***progressive deterioration*** of property through a steadily operating cause, such as the steady weakening of a foundation from wind and weather or the infestation of termites, is not a deductible loss.

Theft

A theft is the unlawful taking and removing of your money or property with the intent to deprive you of it. It includes, but is not limited to, larceny, robbery, and embezzlement. If money or property is taken as a result of extortion, kidnaping, threats, or blackmail, it may also be a theft. You need to show that the taking of your property was illegal under the law of the state in which it occurred and was done with criminal intent.

Mislaid or lost property. The mere disappearance of money or property is not a theft. However, an accidental loss or disappearance of property may qualify as a casualty if it results from an identifiable event that is sudden, unexpected, and unusual.

Proof of loss. To take a deduction for a casualty or theft loss, you must be able to show there actually was a casualty or theft, and you must be able to support the amount you take as a deduction.

For a ***casualty,*** you should be able to show:

1) The type of casualty and when it occurred,
2) That your loss was the direct result of the casualty, and
3) That you were the owner of the property, or, if you leased the property from someone else, that you were liable, under a contract, to the owner for the damage.

For a ***theft,*** you should be able to show:

1) When you found that your property was missing,
2) That your property was actually stolen, and
3) That you were the owner of the property.

How To Figure a Loss

If you have a loss to business or income-producing property, you must figure your loss separately for each item that is stolen, damaged, or destroyed.

Total loss of business property. If your business property is completely destroyed (becomes totally worthless), your deductible loss is the adjusted basis of the property, minus any salvage value and any insurance or other reimbursement you receive or expect to receive. Figure the loss without taking into account any decrease in fair market value, discussed later.

Partial loss of business property. In a partial destruction, the deductible loss is the decrease in fair market value of the property or the adjusted basis of the property, whichever is less. This amount must be reduced by any insurance or other reimbursement you receive or expect to receive.

Figure each casualty separately. You must figure separately each individual identifiable property damaged or destroyed. If casualty damage occurs to both a building and trees on the same piece of property, the loss is measured separately for the building and the trees.

Stolen business property. If your business property is stolen, your deductible loss is your adjusted basis in the property, reduced by any insurance or other reimbursement you receive or expect to receive.

Leased property. If you are liable for damage from fire, storm, shipwreck, or other casualty to property you lease from someone else, your casualty loss is the amount you must pay to repair the property, reduced by any insurance or other reimbursement you receive or expect to receive. You deduct your loss in the year the liability becomes fixed, not the year it is paid. The lessee is not entitled to a loss deduction until liability under the lease is "ascertainable with reasonable accuracy."

Decrease in fair market value. To figure the decrease in fair market value due to casualty or theft, you must make a determination of the fair market value of your property immediately before and after the loss. The decrease is the difference between the value of the property immediately before and immediately after the casualty. Fair market value is defined in Chapter 6. These values should be determined by appraisals.

Appraisals. The difference between the fair market value of property immediately before a casualty and immediately afterwards should be determined by a competent appraiser. The appraiser's knowledge of sales of comparable property and conditions in the area, knowledge of your property before and after the casualty, and method of determining the amount of the loss are important elements for proving a casualty loss.

Cars. The books issued by various automobile organizations may be useful in figuring the value of your car. You can use the wholesale or trade-in value as given in these books, and modify that for such factors as mileage and condition of your car. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Repair cost. The cost of cleaning up or repairing damaged property after the casualty may be a measure of the decrease in fair market value if:

1) The repairs are needed to bring the property back to its condition before the casualty,
2) The cost of repairs is not excessive,
3) The repairs do no more than take care of the damage, and
4) The value of the property after the repairs is no more than its value before the casualty.

Costs for protection against future casualties are not deductible but should be capitalized as permanent improvements. An example would be the cost of a levee to stop flooding.

General decline in market value. The decrease in the value of your business property is not deductible simply because it is in or near an area that had a casualty, and might again have a casualty. You are allowed a loss only for actual casualty damage to your business property.

Income loss. A loss of future profits is not deductible. For example, if an ice storm damages standing timber and reduces its rate of growth or the quality of future timber, the loss is not deductible. To qualify as a casualty, the damage must actually cause existing timber to be unfit for use.

However, if you sell the timber downed as a consequence of a casualty, the proceeds from the sale may be treated as a reimbursement, and qualify for postponement of gain. See *Replacement property,* later.

Related expenses. The related expenses you have due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not deductible as casualty or theft losses. However, they may be deductible as business expenses.

Loss of inventory. A casualty or theft loss of inventory, including items you hold for sale to customers, is automatically claimed through the increase in the cost of goods sold by properly reporting your opening and closing inventories. This loss should not be claimed again as a casualty or theft loss. If you take the loss automatically through the increase in the cost of goods sold, any insurance or other reimbursement you receive for the loss must be included in gross income.

You can choose to take the loss separately. If you take the loss separately, you must eliminate the items by making a downward adjustment to opening inventory or to purchases.

If you take the loss separately, you should reduce the loss by the amount of the reimbursement you received rather than include that amount in gross income. If you do not receive the reimbursement by the end of the year, you may not claim a loss to the extent that you have a reasonable prospect of recovery. See *Insurance and Other Reimbursements,* later.

Basis of property. The basis of property damaged or destroyed by a casualty is reduced by the allowable casualty loss deduction. The basis must be further reduced by any insurance or other reimbursement you receive.

Example 1. Your business truck is involved in an accident. After appraisals have been made, you determine the loss to be $2,000. You carry $250 deductible insurance. You receive $1,750 from the insurance company. Your deductible casualty loss is $250 ($2,000 minus $1,750 insurance received). The basis of your truck must be reduced by your deductible casualty loss, $250, and further reduced by the $1,750 of insurance received.

Example 2. Before being partly destroyed by fire, your building had an adjusted basis of $115,000. Its value was $130,000 just before the fire, $120,000 immediately after. You collected $10,000 insurance. You have no casualty loss deduction because the insurance you received was equal to your casualty loss. The basis of your building is reduced by $10,000, the amount of the insurance.

Replacing and restoring property. Amounts paid to replace or restore property damaged or destroyed by a casualty are not business expenses, but are capital expenses and should be added to the remaining adjusted basis of the property. These adjustments are needed to figure your adjusted basis in the property. See Chapter 6.

When to deduct losses. Casualty losses are generally deductible only in the tax year in which the casualty occurred. This is true even though the damaged property may not be repaired or replaced until a later year.

Theft losses are generally deductible only in the year in which you discover your property was stolen. You must be able to show that there was a theft, but you do not have to know when the theft occurred.

Disaster area losses. If you have a deductible loss from a disaster that occurred in an area determined by the President of the United States to be eligible for federal disaster assistance, you may choose to deduct that loss on your return for the immediately preceding tax year. If you make this choice, the loss will be considered as having occurred in the preceding year.

Disaster loss to inventory. If your inventory loss is from a disaster in an area determined by the President of the United States to be eligible for federal assistance, you may choose to deduct the loss on your return for the immediately preceding year. However, you must decrease your opening inventory for the year of the loss so that the loss will not show up again in inventories.

Disaster unemployment pay. Disaster unemployment assistance payments are unemployment benefits that are taxable. See Publication 525, *Taxable and Nontaxable Income.*

Insurance and other reimbursements. If you receive insurance or another type of reimbursement for your loss, you must subtract the reimbursement from the amount of the loss when you figure your deduction. You cannot deduct the part of a casualty or theft loss for which you are reimbursed.

If you expect to be reimbursed, but have not yet received payment, you must still subtract the expected reimbursement from the loss. But, if you determine with reasonable certainty that you will not receive all or part of the loss, you may deduct for that year the amount of loss that is not reimbursed.

Example. Your business automobile, with a fair market value of $4,000 and an adjusted basis of $3,000, was completely destroyed in a collision with another car in 1989, as the result of the negligence of the other driver. As of December 31, 1989, it was reasonable to believe that you would recover the total damages from the owner of the other car. You do not have a deductible loss in 1989. In January 1990 the court awards you a judgment of $4,000, but in July 1990 you can show with reasonable certainty that the other driver has nothing against which you can enforce your judgment. You may claim a $3,000 loss in 1990.

Grants. Grants you received under the Disaster Relief Act do not have to be included in your gross income. However, you may not deduct a casualty loss or medical expense for which you are specifically reimbursed by the grant.

Reimbursement in a later year. If you receive reimbursement for loss in a later year, and if you had deducted the loss, you must include the reimbursement in income to the extent your deduction reduced your tax. You do not refigure the tax for the year in which you claimed the deduction.

Gain on reimbursement. If you receive reimbursement that is more than your adjusted basis in the property, you have a gain. You have a gain only if the reimbursement is more than your adjusted basis. It does not matter if the reimbursement is more than the decrease in fair market value. If you have a gain, you may have to pay the tax on it, or you may be able to postpone reporting the gain. See *Postponement of Gain,* later.

Reimbursement from creditors or suppliers. If your creditors forgive part of what you owe them because of your inventory loss, this amount is treated as a reimbursement. It is accounted for in the same manner as reimbursement from insurance, discussed earlier.

Part Business and Part Personal-Use Property

When property is partly personal-use and partly business or income-producing property, the casualty or theft loss deduction must be figured as though there were two separate casualties or thefts—one affecting the personal-use property and the other affecting the business or income-producing property.

Nonbusiness property. You may deduct only the amount of your total nonbusiness casualty and theft losses that is more than 10% of your adjusted gross income. You also must first reduce each separate casualty or theft loss by $100.

For more information on losses to nonbusiness property, see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

Example. You own a 3–story building that you built on leased land. You use two floors (⅔ of the building) in your business and you live on the third floor (⅓ of the building). The cost of the building was $140,000 and you made no further improvements or additions to it. A flood in March damaged the entire building. The fair market value of the building was $133,000 immediately before the flood and $120,000 afterwards. Your insurance company reimbursed you $9,000 for the flood damage. Depreciation on the business part of the building before the flood totaled $8,400. Your adjusted gross income is $50,000.

You have a deductible business casualty loss of $2,267. You do not have a deductible personal casualty because of the $100 rule and the 10% rule. You figure your loss as follows:

	Business loss	Personal loss
1) Adjusted basis of building before flood:		
Business portion (cost $93,333 minus depreciation $8,400)	$84,933	
Personal-use portion (basis equals cost)		$46,667
2) Value before flood (total $133,000)	$88,667	$44,333
3) Value after flood (total $120,000)	80,000	40,000
4) Decrease in value	$ 8,667	$ 4,333
5) Amount of loss (line 1 or line 4, whichever is less)	$ 8,667	$ 4,333
6) Minus: Insurance	6,000	3,000
7) Loss after reimbursement	$ 2,667	$ 1,333
8) Minus: $100 on nonbusiness property	-0-	100
9) Loss after $100 rule	$ 2,667	$ 1,233
10) Minus: 10% of $50,000 on nonbusiness property	-0-	5,000
11) Deductible business loss	$ 2,667	
12) Deductible personal loss		-0-

Listed property. Special rules apply to listed property not used 100% in your business. Listed property includes any passenger automobile, other property used for transportation, property used for entertainment such as photographic, communication, and video recording equipment and computers, and related peripheral equipment not used exclusively at a regular business location.

For listed property used in your trade or business, the adjusted basis of property is figured as if all the use of the property were in your trade or business. This will require that the adjusted basis of listed property be reduced by depreciation figured as if 100% of the use of the property were for business, even if a lesser amount was allowable because the property was not used 100% in your trade or business.

For more information on listed property, see Publication 534, *Depreciation.*

Condemnation

Condemnation is the process by which private property is legally taken, without the owner's consent, for public use. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take the property. The owner receives money or property in exchange for the taken property. A condemnation is like a forced sale, the owner being the seller and the condemning authority being the buyer.

Example. A local government authorized to acquire land for public parks told you that it wished to acquire your property. After the local government took action to condemn your property, you went to court to keep your property. But the court ruled for the local government. The government took your property and paid you an amount fixed by the court. This is a condemnation of private property for public use.

Threat of condemnation. You are under threat of condemnation if a representative of a government body or a public official authorized to acquire property for public use tells you that the body or official has decided to acquire your property, and from this you have reasonable grounds to believe that, if you do not sell voluntarily, your property will be condemned.

You are under threat of condemnation if you sell your property to someone other than the condemning authority, provided you have reasonable grounds to believe that your property will be condemned. If the buyer of this property knows it is under threat of condemnation at the time of purchase and sells the property to the condemning authority, such a forced sale will also qualify as a condemnation.

Reports of condemnation. You are also under threat of condemnation if you learn of a decision to acquire your property for public use through a report in a newspaper or other news media, and this report is confirmed by a representative of the government body or public official involved. You must have reasonable grounds to believe that they will take the necessary steps to condemn your property if you do not sell voluntarily. If you relied on oral statements made by a government representative or public official, the Internal Revenue Service may ask you to get written confirmation of the statements.

Example 1. A public utility company that does not have the authority to condemn property, but can get that authority, wants to acquire your property. If, during negotiations, a representative tells you that your property will be condemned and also reveals the identity of the condemning authority, you have reasonable grounds to believe that condemnation will occur if you do not voluntarily sell the property.

Example 2. Tom Young received a health department notice that a building he owns is unfit and will be condemned if necessary repairs are not made. He is not under threat of condemnation because the notice does not relate to a condemnation of private property for public use.

Property voluntarily sold. A voluntary sale of property may be treated as a forced sale that qualifies as a condemnation if the property had a "substantial economic relationship" to property of yours that was condemned. A substantial economic relationship exists if together the properties were one economic unit. You must show that a suitable nearby property of a like kind to the condemned property is not available, and you cannot continue to do business as before.

This treatment will not apply if you do not own both properties.

Example. Green Corporation rented its manufacturing plant from your father and an adjacent warehouse from you. Your father owns 51% of Green's stock and the remainder is owned equally by you and your brother. Last year your father sold his plant under threat of condemnation. You sold your warehouse because the plant was relocated. Your voluntary sale is not a condemnation because you do not own the condemned property (the plant).

Easements. If you grant an easement on your property (for example, a right-of-way over it) under condemnation or threat of condemnation, you are considered to have made a forced sale, even though you keep the legal title. Although you figure gain or loss on the easement in the same way as a sale of property, the gain or loss is treated as a gain or loss from a condemnation. See *Gain or Loss*, later.

Condemnation award. A condemnation award is the money you are paid or the value of other property you receive for your condemned property. The award is also the amount you are paid for the sale of your property under threat of condemnation.

Deposits made by the condemning authority. The condemning authority may deposit with the clerk of the court, for example, any award that is being disputed. You are considered to have received the award in the first year in which you have an unrestricted right to it. This can occur when you are able to withdraw the money for your own use. You must report the award on your return for that year, not for the year in which the dispute was settled.

Amounts withheld from award. Amounts withheld from the award to pay your debts are considered paid to you. Amounts paid directly to the holder of a mortgage or other lien (claim) against your property are part of your award, even though the debt attaches to the property and is not your personal liability.

Example. The state condemned your property for public use. The award was set at $200,000. The state paid you only $148,000 because it paid $50,000 to your mortgage holder and $2,000 of accrued real estate taxes. You are considered to have received the entire $200,000 as a condemnation award.

Net condemnation award. A net condemnation award is the total award you received or are considered to have received for the condemned property minus your expenses of obtaining the award. If only a part of your property was condemned, you must also reduce the award by any severance damages and any special assessment levied against the part of the property you retain. See *Severance damages* and *Special assessment withheld from award*, discussed later.

Interest on award. If the condemning authority pays you interest for its delay in payment of your award, it is not part of the condemnation award. You should report the interest separately as ordinary income.

Payments to relocate. Payments you receive to relocate and replace housing because you have been displaced from your home, business, or farm as a result of federal or federally assisted programs are not part of the condemnation award. Do not include them in your income. The replacement housing payments are added to the cost of your newly acquired property.

Severance damages. Severance damages are compensation paid to you if part of your property is condemned and the value of the part you keep is decreased because of the condemnation.

If part of your property is condemned, the part you keep may be damaged as a result of the condemnation.

For example, you may receive severance damages if your retained property will be subject to flooding. Severance damages may also be given to you if you must replace fences, dig new wells or ditches, or plant trees to restore your remaining property to the same usefulness it had before the condemnation.

The contracting parties should agree on the amount of the severance damages and put that in writing. If this is not done, all the proceeds from the condemning authority are considered awarded for your condemned property.

You may not make a completely new allocation of the total award after the transaction is completed. However, you may show how much of the award both parties intended to be for severance damages. The severance damages part of the award is determined from all the facts and circumstances.

Treatment of severance damages. You must first reduce your severance damages by your expenses in obtaining the damages. You then reduce them by any special assessment levied against the remaining part of the property, if the assessment was withheld from the award by the condemning authority. The balance is your net severance damages. You then reduce the basis of the remaining property by your net severance damages.

If the amount of severance damages is based on damage to a specific part of the remaining property, you may reduce only the basis for that part by the net severance damages. If your net severance damages are more than the basis of the remaining property, you have a gain. You may choose to postpone the gain by buying replacement property. See the later discussion, *Postponement of Gain*.

If you restore the remaining property to its former use, you can choose to treat the cost of restoring it as the cost of replacement property. You can also make this choice if you spend the severance damages, together with other money you received for the condemned property, to acquire nearby property that will allow you to continue your business. If a suitable nearby property is not available and you are forced to sell the remaining property and relocate in order to continue your business, see *Property voluntarily sold*, discussed earlier.

Consequential damages. Consequential damages and similar awards may be paid to you for damage from improvements made to your property by a state, city, or other public body that did not actually take your property. These amounts are awarded for the same reasons as severance damages, discussed earlier, and are treated in the same way as severance damages.

Expenses of obtaining a condemnation award and severance damages. Subtract the expenses of obtaining a condemnation award, such as legal, engineering, and appraisal fees, from the amount of the total award. You also subtract the expenses of obtaining the severance damages from the severance damages paid to you. If part of your condemnation award is for severance damages, determine which part of your expenses is for each part of the award. If you cannot do this, you must make a proportionate allocation.

Special assessment withheld from award. When part of your property is condemned, you must reduce the condemnation award by the expenses of obtaining the award and by any amount withheld because of a special assessment levied against the remaining property. An assessment may be levied if the remaining part of your property is benefited by the improvement resulting from the condemnation. Examples of improvements that may cause a special assessment are widening of a street or installation of a sewer.

The assessment must be withheld from the award. The award cannot be reduced by any assessment levied after the award is made, even if the assessment is levied in the same year the award is made.

Example. To widen the street in front of your home, the city acquired 25 feet of your land. You were awarded $5,000 for this and spent $300 to get the award. Before paying the award, the city levied a special assessment of $700 for the street improvement against your remaining property. The city then paid you only $4,300. Your net award is $4,000 ($5,000 total award minus $300 expenses in obtaining the award and $700 for the special assessment withheld).

If the $700 special assessment were not withheld from the award and you were paid $5,000, your net award would be $4,700 ($5,000 minus $300). The net award is not changed, even if you later paid the assessment from the amount you received.

Severance damages included in award. If the award includes severance damages, you must first reduce the severance damages by the special assessment withheld. Any balance is used to reduce the condemnation award.

Gain or Loss

If your net condemnation award is more than the adjusted basis of the condemned property, you have a gain. You may postpone reporting the gain. If your award is less than the adjusted basis of the property, you have a loss. If your loss is from property you held for personal use, you cannot deduct it. You must report any deductible loss in the tax year in which it happened.

For a casualty or theft, you have a loss if the amount you receive is less than the decrease in the fair market value of the property, and the decrease is less than the adjusted basis. You figure gain or loss on the total destruction of business property by comparing the amount of reimbursement received with the adjusted basis of the property, without taking into account fair market value.

Amount received. The amount you receive includes any money plus the fair market value of any property you receive in exchange for the condemned, damaged, destroyed, or stolen property, minus your expenses in obtaining the award. For casualties or thefts, it includes insurance or other reimbursement received or expected to be received for the loss.

Lump-sum reimbursement. If you have a casualty or theft loss of several assets at the same time, you must divide the lump-sum reimbursement among the assets according to the fair market value of each of the assets at the time of the loss. You must figure the gain or loss separately for each asset that has a separate basis.

Part business or part rental. If you used part of your condemned property as your home and part as business or rental property, you must treat each part as a separate property and figure your gain or loss separately for each part because gain or loss may be treated differently.

Some examples of this kind of property are a farm or ranch you operate and live on, a building in which you live and operate a grocery, and a building in which you live on the first floor and rent out the second floor.

Postponement of Gain

Do not report the gain on condemned, damaged, destroyed, or stolen property if you receive property that is similar or related in service or use to it. Your basis for the new property is the same as your basis for the old property.

Choosing to postpone gain. You must ordinarily report the gain if you receive unlike property or money as reimbursement.

You can choose to postpone reporting the gain if, within a specified replacement period, discussed later, you purchase:

1) Property similar or related in service or use to the condemned, etc., property, or
2) A controlling interest (at least 80%) in a corporation owning such property.

To postpone all the gain, the cost of your replacement property must be equal to or more than the amount realized (reimbursement) for your property.

If you are a member of a partnership or a shareholder in a corporation that owns the condemned, damaged, destroyed, or stolen property, only the partnership or corporation, and not you, can choose to postpone reporting the gain.

Changing your mind. You can change your mind about reporting or postponing the gain at any time before the end of the specified replacement period. However, see *Substituting replacement property,* later.

Example. Your property was condemned and you had a gain of $5,000. You reported the gain on your return for the year in which you received it, and paid the tax due. You buy replacement property within the replacement period. You used all but $1,000 of your gain to buy the replacement property. You now change your mind and want to postpone the tax on the $4,000 of gain spent for the replacement property. You should file a claim for refund on Form 1040X, *Amended U.S. Individual Income Tax Return.* Explain on Form 1040X that you previously reported the entire gain from the condemnation, but you now want to report only the part of the gain ($1,000) not spent for replacement property.

Replacement property. You must buy replacement property for the specific purpose of replacing your condemned, damaged, destroyed, or stolen property. You do not have to use the actual award or reimbursement from your old property to acquire the replacement property. Property or stock you acquire by gift or inheritance does not qualify as replacement property.

The proceeds from the sale of timber downed as a consequence of a casualty (such as high winds, earthquakes, or volcanic eruptions) may be treated as a replacement, and qualify for postponement of gain if they are invested in other property similar or related in service or use to the property converted within the specified replacement period.

Your replacement property must be similar or related in service or use to the property it replaces. If the condemning authority acquired real estate that you used in your business or for rental or investment purposes, see *Special rule for certain real property,* later.

"Fee simple" property to be used in your trade or business or for investment can qualify as replacement property that is similar or related in service or use to a condemned 15–year leasehold if the "fee simple" property is used in the same business and for the identical purpose as the condemned leasehold.

A "fee simple" property interest generally is one in which the owner is entitled to the entire property, with unconditional power to dispose of it during his or her lifetime. A leasehold is property held under a lease usually for a term of years.

Advance payment. If you pay a contractor in advance to build your replacement property, you are not considered to have purchased replacement property unless it is finished before the end of the replacement period.

Similar or related in service or use. The meaning of similar or related in service or use depends on whether you are an owner-user or an owner-investor.

Owner-user. If you are an owner-user, similar or related in service or use means that replacement property must function in the same way as the property it replaces.

Example. Your home was destroyed by fire. Your insurance reimbursement resulted in a gain. To postpone reporting the gain, you must replace your home with another home that costs at least as much as the reimbursement. If you replace your home with an apartment house that you buy to rent out to others, you cannot choose to postpone reporting the gain because the apartment house is not similar or related in service or use to your destroyed home.

Owner-investor. If you are an owner-investor, similar or related in service or use means that any replacement property must have the same relationship of services or uses to you as the property it replaces. You decide this by determining:

1) Whether the properties are of similar service to you,
2) The nature of the business risks connected with the properties, and
3) What the properties demand of you in the way of management, service, and relations to your tenants.

Example. You owned land and a building that you rented to a manufacturing company. The building was condemned. During the replacement period, you had a new building constructed on other land you already owned. You rented out the new building for use as a wholesale grocery warehouse. Because the replacement property is also rental property, the two properties will be considered similar or related in service or use if there is a similarity in your management activities, the amount and kind of services you provide to your tenants, and the nature of your business risks connected with the properties.

Controlling interest in a corporation. You may replace property by acquiring a controlling interest in a corporation that owns property similar or related in service or use to your condemned, damaged, destroyed, or stolen property. You may postpone the tax on your entire gain if the cost of the stock that gives you controlling interest is equal to or more than the amount realized (reimbursement) for your condemned, damaged, destroyed, or stolen property. You have controlling interest if you own stock having at least 80% of the combined voting power of all classes of voting stock and at least 80% of the total number of shares of all other classes of stock.

Special rule for certain real property. A special rule applies to the replacement of real property used in your trade or business or held for investment that is condemned or sold under threat of condemnation. Real property means property relating to land, and generally anything that is erected on, growing on, or attached to the land. This special rule does not apply to the acquisition of real property held as stock in trade or primarily for sale.

In such cases, you may postpone reporting your gain on the condemnation of your real property if, within the replacement period, you replace it with "like-kind property" that will be used in your trade or business or held for the production of income or for investment. If you do not replace the condemned property with like-kind property, you may still postpone reporting the gain by replacing it with property that is similar or related in service or use.

Like-kind property. Like-kind property, for purposes of the special rule, generally means real property. It does not matter if the condemned property or your replacement property is improved or unimproved. In determining whether the two properties qualify as like-kind property, you should consider the nature and character of each property.

For example, replacement with real property held for use in a trade or business or for the production of income for the following are like-kind exchanges:

1) Easements,
2) Rights-of-way,
3) Leaseholds for a term of 30 years or more (the term includes the initial term of the lease and all optional renewal periods),
4) Perpetual water rights, if they are considered real property rights under state law, and
5) Any similar continuing interests in real property.

Example 1. You planned to build warehouses for your business on your unimproved property. The unimproved property was condemned before you built the warehouses. You bought improved real property that had a garage, a service station, and salesrooms on it. You rent out these buildings. The improved real estate qualifies as replacement property because it is held for the production of income and is of a like kind.

Example 2. Assume that in Example 1 you used the amount you received from the condemnation to buy a controlling interest in a corporation that owns property that has a garage, a service station, and salesrooms on it. Your purchase of the controlling interest does not qualify as replacement property because stock is not like-kind property to unimproved property nor is the new property similar or related in service or use to your unimproved property.

Outdoor advertising displays. You may make an election to treat a qualifying outdoor advertising display as real property if you did not claim a section 179 deduction for the display, or take an investment credit in a previous year. You cannot revoke this election unless you get the consent of the Internal Revenue Service.

If you make this election and you replace your condemned, etc., outdoor advertising display with real property in which you hold a different kind of interest, your replacement property may qualify as like-kind property. For example, real property purchased to replace a destroyed billboard and leased property on which the billboard was located qualify as property of a like kind.

An outdoor advertising display is a sign or device that is rigidly assembled and permanently attached to the ground, a building, or any other permanent structure that is used for commercial or other advertisement to the public.

Basis of replacement property. If property was acquired as the result of a condemnation, the basis of the replacement property will be the same as that of the condemned property, reduced by any money received not spent for replacing the property, and increased by the amount of gain or decreased by the amount of loss to be reported on your income tax return. If you spend more for the replacement property than you received as a result of the condemnation, you add that amount to the basis of the replacement property. For more information on basis, see Chapter 6.

Replacement period. To postpone reporting your gain from a condemnation, casualty, or theft, you must buy replacement property within a specified period of time. This is the "replacement period."

Casualty or theft. The replacement period for a casualty or theft begins on the date the property was damaged, destroyed, or stolen. The replacement period ***ends 2 years*** after the close of the first tax year in which any part of the gain on the casualty or theft is realized.

Condemnation. The replacement period for a condemnation begins on the earlier of:

1) The date on which the condemned property was disposed of, or
2) The date on which the threat of condemnation began.

Specified replacement period. The replacement period ***ends 2 years*** after the close of the first tax year in which any part of the gain on the condemnation is realized.

If ***real property held for use in a trade or business*** or for investment (not including property held primarily for sale) is condemned, the replacement period ***ends 3 years*** after the close of the first tax year in which any part of the gain on the condemnation is realized.

Example. You are a calendar year taxpayer. You were notified by the city council on December 1, 1990, of its intention to acquire by negotiation or by condemnation your real property used in your business. On June 1, 1991, when the property had an adjusted basis of $40,000 to you, the city condemned the property and paid you $50,000. The replacement period began on December 1, 1990, the date you were notified of the intention to condemn the property. Because the condemned property was real estate used in your business, the replacement period ends on December 31, 1994, three years after the last day of the year in which the gain was realized.

Replacement property acquired before the condemnation. If you acquire your replacement property after there is a threat of condemnation, but before the actual condemnation, and you still hold the replacement property at the time of the condemnation, you acquired your replacement property within the replacement period. Property you acquire before there is a threat of condemnation does not qualify as replacement property acquired within the replacement period.

Constructive receipt of condemnation payments. The replacement period ends 2 and/or 3 years after the close of the first tax year in which any part of the gain is realized, that is, when you receive payments that exceed your basis in the property. This applies even though the amounts received are only partial or advance payments and the full amount of the award has not yet been determined. A replacement will be too late if you wait for a final determination that does not take place in the applicable replacement period after gain was first realized.

In addition, the replacement period begins when the condemning authority makes deposits into the court and you withdraw amounts in excess of your basis.

Accrual basis taxpayers should be aware that gain begins to accrue in the year of condemnation and not in the year of payment.

Extension. You may get an extension of the replacement period if you apply to the District Director of the Internal Revenue Service for your area. You should apply before the end of the replacement period. Your application should contain all the details about the need for the extension. You may file an application within a reasonable time after the replacement period ends if you can show reasonable cause for the delay. An extension of time will be granted if you can show reasonable cause for not making the replacement within the regular period.

How to postpone a gain. If your property is condemned, damaged, destroyed, or stolen, you should report your election to postpone your gain, along with all the necessary details, on your return for the tax year in which you realize the gain.

Replacement property acquired before return filed. If you acquire replacement property before you file your return for the year in which gain is realized, you must attach a statement to your return. The statement should show the amount realized from the condemnation, casualty, or theft. It should also show how you figured the gain, and any gain to be reported.

Substituting replacement property. Once you have designated certain property as replacement property, you may not substitute other qualified replacement property in its place. But if previously acquired replacement property is determined not to be qualified replacement property, you may substitute other qualified replacement property if it is acquired within the replacement period.

Replacement property acquired after return filed. If you intend to buy replacement property after you file your return for the year in which the gain is realized, you must attach a statement to your return. The statement should show all the facts relating to the condemnation, casualty, or theft. It should also show how you figured the gain, and say that you choose to replace the property within the required replacement period.

You then attach another statement to your return for the year in which you buy the replacement property. The statement should contain detailed information on the replacement property. If the replacement is made in separate years, a statement must be made with the return for each year. The statement should contain detailed information on the balance of the replacement property.

Amended return. You must file an amended return and refigure your tax liability for the tax year in which you made the choice if:

1) You did not acquire replacement property within the required replacement period,
2) You acquired replacement property within the required replacement period but at a cost less than you expected when you made the election, or
3) You make a decision not to replace the property.

Effect of taxpayer's death. If a taxpayer dies in the year the gain is realized, but before replacement property is acquired, there can be no election to postpone the gain. Instead, the gain must be reported on the decedent's final income tax return.

26. Reporting Gains and Losses

Important Change for 1990

New Form 8824. Beginning in 1990, if you exchange property in a like-kind transaction, you must file Form 8824, *Like-Kind Exchanges*, in addition to Schedule D (Form 1040) or Form 4797.

This chapter discusses the reporting of capital gains and losses and ordinary gains and losses from sales, exchanges, and other dispositions of property. It covers the use of Schedule D (Form 1040), Form 4684, and Form 4797.

Schedule D

Capital gains and losses as well as the exchange of like-kind property are reported on Schedule D (Form 1040). This schedule is also used to figure capital gains and the limit on capital losses.

Any net section 1231 gain from Part I, Form 4797, is also reported on Schedule D (Form 1040). Section 1231 gains and losses are discussed in Chapter 22. Form 4797 is discussed later in this chapter.

Note that although references in this discussion are to Schedule D (Form 1040), the rules discussed here apply also to taxpayers other than individuals. The rules for property held for personal use, however, will not usually apply to taxpayers other than individuals. Form 4797 is used along with Form 1040, as well as with Forms 1065, 1120, and 1120S. See the illustrated example of the filled-in return Form 1065, near the end of this publication.

New Form 8824. Beginning in 1990, you must file Form 8824, *Like-Kind Exchanges*, in addition to Schedule D (Form 1040) when you exchange property in a like-kind transaction.

Form 1099-B. If you sold property, such as bonds, stocks, commodities, etc., you should receive Form 1099-B or an equivalent statement from your broker. Use Form 1099-B or the equivalent statement to fill in line 1 of Schedule D (Form 1040).

Whether or not you receive Form 1099-B, you must report all taxable sales of stocks, bonds, commodities, etc., on Schedule D. For more information about figuring gains and losses from these transactions, see *Sales and Trades of Investment Property*, in Publication 550.

Short-term gains and losses. Gain or loss on the sale or exchange of capital assets held one year or less is a short-term capital gain or loss. Report it in Part I.

Gain. Gain on the sale or exchange of property held for personal use (such as your residence) and held for one year or less is a short-term capital gain and is reported in Part I. ***Loss*** on the sale or exchange of property held for personal use is not deductible.

Combine your share of short-term capital gains or losses from partnerships, S corporations, or fiduciaries with your short-term capital loss carryover and other short-term gains and losses to figure net short-term capital gain or loss.

Long-term gains and losses. A gain or loss on the sale or exchange of capital assets held more than one year is a long-term capital gain or loss. Report it in Part II.

Gain. Gain on the sale or exchange of property held for personal use and held more than one year is a long-term capital gain. Report it in Part II. ***Loss*** on the sale or exchange of such property is not deductible.

Net long-term gain or loss. A net section 1231 gain from Part I of Form 4797, after reduction for prior years net section 1231 losses, if applicable, is a long-term capital gain. See Chapter 22. Report the gain in Part II of Schedule D (Form 1040). Report the following in Part II:

1) Capital gain distributions from regulated investment companies, mutual funds, and real estate investment trusts.
2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries.
3) Long-term capital loss carryovers.
4) Your capital gain distribution, unless you do not need to report any other capital gains or losses. In this case report capital gain distributions on Form 1040.

The result from combining these items is your net long-term capital gain or loss.

Total net gain or loss. You figure your total net gain or loss by combining your net short-term capital gain or loss (line 8, Part I) with your net long-term capital gain or loss (line 17, Part II). Enter the result on line 18, Part III.

Capital loss carryover. If your net capital loss is more than the yearly limit on capital loss deductions, you may carry over the excess to later years until it is completely used up. When you carry over a loss, it stays as either long term or short term. Therefore, a long-term capital loss you carry over will reduce long-term gains of the current year before it reduces short-term gains of the current year.

You carry over the amount of a capital loss that is more than the amount of allowable loss to the next year and treat it as if you had incurred it in that year. When you figure the amount of any capital loss carryover in a later tax year, you must take into account any deductions for capital losses allowed in earlier years.

Example. Bob and Gloria Sampson sold property in 1990. The sale resulted in a capital loss of $7,000. The Sampsons had no other capital transactions. On their joint 1990 return, the Sampsons deduct $3,000, the lower of $3,000 or $7,000. The unused part of the loss, $4,000 ($7,000 − $3,000), is carried over to 1991. If the Sampsons had no taxable income in 1990, the amount of their carryover to 1991 would still be $4,000. The allowable $3,000 deduction is considered used in 1990, even if they had no taxable income.

If the Sampsons' capital loss had been $2,000, their capital loss deduction would have been $2,000, the lower of $3,000 or $2,000. They would have no carryover to 1991.

Figuring your capital loss carryover. Complete Part IV of Schedule D (Form 1040) to determine the part of your capital loss for 1990 that you can carry over to 1991.

Joint and separate returns. On a joint return, the capital gains and losses of a husband and wife are figured as though they are the gains and losses of an individual. If you are married and filing a separate return, your yearly capital loss deduction is limited to $1,500 (one-half of the $3,000 limit allowed on a joint return). Neither you nor your spouse may deduct any part of the other's loss.

If you and your spouse once filed separate returns and are now filing a joint return, you and your spouse must combine each of your capital loss carryovers. However, if you and your spouse once filed jointly and are now filing separately, any capital loss carryover can be deducted only on the return of the person who actually had the loss.

Death of taxpayer. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed on the decedent's behalf. The capital loss limits discussed earlier still apply in this situation. Even if the loss is greater than the limit, the excess cannot be deducted by the decedent's estate or carried over to following years.

Form 4797

A sale, exchange, or involuntary conversion of property used in your trade or business or held for the production of rents or royalties sometimes results in either a capital gain or loss, or an ordinary gain or loss. All or part of any gain from the disposition of such property may be ordinary gain from depreciation under the rules of Chapter 23. Gains and losses from involuntary conversions of capital assets (property held for personal use or for investment) may be treated as capital or ordinary gains and losses, depending on the circumstances.

Form 4797. Use Form 4797 to report these transactions and to figure the amount of ordinary or capital gain or loss.

Real estate transactions. Information reporting must be provided on certain real estate transactions. For closings in 1990, generally the person responsible for closing the transactions must report to IRS on Form 1099-S, *Statement for Recipients of Proceeds From Real Estate Transactions*, the sale or exchange of the following:

1) A single-family residence, such as a house, townhouse, or condominium unit,
2) A multi-family residence with four or fewer units, or
3) Stock in a cooperative housing corporation.

If you have sold or exchanged the above types of property, the reporting person must give you a copy of Form 1099–S or a statement containing the same information as the 1099–S. Also, use Form 1099–S to fill in the gross proceeds requested on line 1 of Form 4797 or the form you are using to report the sale or exchange.

Note. If you receive or will receive property or services in addition to gross proceeds (cash or notes) in this transaction, the person reporting it is not required to value that property or those services. In that case, the gross proceeds reported on Form 1099–S will be less than the sale price of the property you sold. After you include the gross proceeds amount on line 1 of Form 4797, figure any gain or loss according to the sales price, which is the total amount you realized on the transaction.

New Form 8824. Beginning in 1990, you must file Form 8824, *Like-Kind Exchanges*, in addition to Form 4797 when you exchange property in a like-kind transaction.

Form 4684

A casualty or theft loss of business property or property used in a transaction entered into for profit is always deductible.

Form 4684. Use Form 4684, *Casualties and Thefts*, to figure and report casualty and theft losses and gains. Section B, Part I, has space to figure a gain or loss on four items of business property. List each item or article for which you are claiming a casualty or theft loss. If more than four items of property were damaged or stolen in a single casualty or theft, complete Section B, Part I, of additional Forms 4684, or substitute your own statement for Section B, Part I. The statement must include the same information that is asked for in Section B, Part I.

If you had more than one casualty or theft during the year, use a separate Section B, Part I of Form 4684, for each casualty or theft.

Section B, Part II or Form 4684, is used to summarize all your gains and losses from casualties and thefts of trade or business or income-producing property during the tax year. The summarized information is then carried to other tax forms. Short-term gains and losses are listed separately from long-term gains and losses. Part II also divides losses by the type of property. Losses on business property and property that earns rent or royalty income are listed in column (b)(i). Losses on income-producing property are listed in column (b)(ii). Gains are listed in column (c).

Part VI
The Business Activity

This Part discusses some of the tax rules that may differ, depending on whether you operate your business as a sole proprietor, a partnership, a corporation, or an S corporation.

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27. Sole Proprietorships

This chapter discusses filing requirements for a sole proprietor. It also discusses how a sole proprietor should report the sale or disposition of a business. For information on how to treat the expenses of starting a new business or buying an existing business, see Chapters 5 and 13.

You are a sole proprietor if you are self-employed and are the sole owner of an unincorporated business.

Schedule C

If you are a sole proprietor, you report your income and expenses from your business or profession on Schedule C (Form 1040), *Profit or Loss From Business.* File Schedule C with your Form 1040. Report the amount of net profit or (loss) from Schedule C on line 12 of Form 1040. If you operate more than one business as a sole proprietor, you must prepare a ***separate Schedule C for each business*** and attach each of them to your tax return. If you do not prepare a separate Schedule C for each business, you may have to pay a ***penalty*** because you did not properly report your income and deductions.

Form 1040 is due, for calendar year 1990, by April 15, 1991. If you use a fiscal year, your return is due by the 15th day of the 4th month after the close of your fiscal year. See the *Checklist* on the inside of the back cover.

Automatic extension of time to file. If you cannot file your return on time, use Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return,* to request an automatic 4–month extension.

You may not use Form 4868 if:

1) You want the Internal Revenue Service to figure your tax, or
2) You are under a court order to file your return by the regular due date.

You must file Form 4868 by the date your Form 1040 would be due. When you file Form 4868, you must estimate and pay any tax you will owe.

Withdrawals. If you are a sole proprietor, there is no tax effect if you take money out of your business, or transfer money to or from your business. It is a good idea to set up a drawing account. This will help you identify amounts that are not for business expenses but that are for your own personal use.

Self-employment tax. Generally, if you are a sole proprietor, you will have to pay self-employment tax. See Chapter 32.

Estimated Tax

If you are a sole proprietor, you may have to make estimated tax payments if the total of your estimated income tax and self-employment tax for 1991 will exceed your total withholding and credits by $500 or more.

You use Form 1040–ES, *Estimated Tax for Individuals,* to estimate your tax. See Publication 505, *Tax Withholding and Estimated Tax,* and the instructions for Form 1040–ES for information on estimated taxes.

Underpayment of tax. If you did not pay enough income tax and self-employment tax for 1990 by withholding or by making estimated tax payments, you may have to pay a penalty on the amount not paid. IRS will figure the penalty for you and send you a bill. Or you can use Form 2210, *Underpayment of Estimated Tax by Individuals and Fiduciaries,* to see if you have to pay a penalty and to figure the penalty amount. For more information, see Publication 505.

Sale of a Business

If you are a sole proprietor and sell your business, you are really selling all the individual assets of your business.

Classification of assets. To determine whether the gain or loss on the sale of an asset is capital gain or loss or ordinary gain or loss, you must classify the assets sold as:

1) Capital assets,
2) Real property and depreciable property used in your business and held for more than 1 year (see Chapter 22), and
3) Other property—for example, stock-in-trade, inventory, or property used in your business and held 1 year or less.

Accounts and notes receivable. Accounts and notes receivable acquired in the ordinary course of your business for services rendered, or from the sale of stock-in-trade, are not capital assets. They should be classified in category (3).

Installment notes. Installment notes from the sale of stock-in-trade should be classified in category (3). The gain, which is the difference between the basis of the note and the amount realized, is ordinary income.

Merchandise inventories. Merchandise inventories are not capital assets and belong in category (3).

Land and leaseholds. Land and leaseholds used in your business are not capital assets. If you hold them for more than 1 year, they belong in category (2), and if you hold them 1 year or less in category (3).

Buildings, machinery, furniture, and fixtures. Buildings, machinery, furniture, and fixtures that you use in your business are not capital assets. You should put them in category (2) if you hold them for more than 1 year, and in (3) if you hold them for 1 year or less.

Patents. Patents that you use in your business should ordinarily be classified in category (2) if you hold them more than 1 year, and in (3) if you hold them 1 year or less. But if you are the inventor (or if you are entitled to the same treatment as the inventor, as explained under *Inventions,* in Chapter 22) and you sell all substantial rights to patent property or a patent, or an undivided interest in all such rights, to a person other than a related person, treat the sale as a sale of a long-term capital asset and include it in category (1).

Copyrights. Copyrights that you use in your business should be classified in category (2) if you hold them more than 1 year, and in (3) if you hold them 1 year or less. However, if you sell a copyright that you created, or if you sell a copyright that gets its basis from the person who created the property, you should not classify it in category (2). Instead, you should classify it in category (3).

Goodwill. Goodwill is a capital asset. It belongs in category (1). The basis of goodwill is usually its cost if you bought it. When you buy a going business and intend to continue the business, goodwill may be included in the price.

Agreement not to compete. If an agreement not to compete (also called a covenant not to compete) for a fixed number of years can be separated from goodwill, the agreement should be classified in category (3). However, if an agreement not to compete accompanies the transfer of goodwill in the sale of a going concern and its main purpose is to assure the purchaser of the beneficial enjoyment of the goodwill acquired, the agreement cannot be separated from goodwill. It is a capital asset and should be classified in category (1). You must establish from the facts and circumstances in your case whether you have sold goodwill or have entered into an agreement not to compete.

Professional skill or other characteristics of an owner. The amount received from the sale of a professional practice that is for goodwill is determined by the facts in the particular case and not by whether the business is, or is not, dependent solely on the owner's professional skill or other personal characteristics.

If the seller has the right to keep fees collected after the sale for services performed before the sale, or receives payment for giving up all or part of the right to these fees, the amount received is treated as if it was for services performed before the sale rather than to the sale of goodwill, and is ordinary income.

If the seller retains a right to any fees or revenue collected for services performed after the sale, or if the purchaser agrees to pay an amount equal to any part of these fees or revenues, these amounts are ordinary income from the business, not proceeds from the sale of goodwill.

Amounts received by a professional person when admitting partners to that person's practice may be payment for a partial transfer of goodwill (rather than an assignment of anticipated future earnings). In such a case, the goodwill must in fact exist and the consideration allocated to it must actually be a payment for it.

Allocation of selling price. You must allocate the selling price proportionately among all the assets sold. See *Goodwill* in Chapter 22 for a discussion of the allocation rules.

Figuring gain or loss. After classifying each asset sold and allocating the selling price, you are ready to figure your gain or loss. You must figure separately the gain or loss for each asset sold, and then treat it according to its classification. The treatment of assets in categories (1) and (2) is discussed in Chapters 21, 22, and 23.

You should treat the gains or losses relating to assets in category (3) as ordinary income or loss.

Transactions between related parties. If there is a direct or indirect sale or exchange of depreciable property between related parties, any gain will be taxed as ordinary income. Losses between related parties are not allowed. See Chapter 22.

Other disposition of a business. You can change the present form of your business without selling your assets. You may do this by joining one or more persons who want to consolidate their individual businesses into a partnership or other form of organization and by transferring your assets to the new form of business. You may change the form of your business by incorporating a sole proprietorship or a partnership. You also may transfer the property of a sole proprietorship or partnership to a previously existing corporation.

28. Partnerships

A partnership is the relationship between two or more persons who join together to carry on a trade or business. Each person contributes money, property, labor, or skill, and each expects to share in the profits and losses. "Person" when used to describe a partner means an individual, a corporation, a trust, an estate, or another partnership.

Husband-wife partnerships. If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss on Form 1065, *U.S. Partnership Return of Income*.

Spouses should include their respective shares of the partnership income or loss on separate Schedules SE (Form 1040), *Social Security Self-Employment Tax*. Doing this will usually not increase their total tax, but it will give each spouse credit for social security earnings on which retirement benefits are based. Also, see *Family Partnerships*, later.

Partnership income. Partnership profits (and other income and gains) are not taxed to the partnership. Except for certain items that must be stated separately, a partnership determines its income in the same way that an individual does.

The partnership, not the partners, makes most choices about how to compute income. These include choices for accounting methods (Chapter 4), depreciation methods (Chapter 12), accounting for specific items such as depletion, amortization of certain organization fees, amortization of business start-up costs of the partnership, and reforestation expenditures (Chapter 13), installment sales (Chapter 24), and nonrecognition of gain on involuntary conversions of property (Chapter 25).

However, each partner, not the partnership, decides how to to treat foreign and U.S. possessions taxes, certain mining exploration expenses, and income from discharge of indebtedness.

Generally, a partnership must use the same tax year as its majority partners. For exceptions to this rule and for more information, see Chapter 3.

Form 1065. Every partnership doing business in or having income from sources within the United States is required to file Form 1065 for its tax year. This is an information return and must be signed by a general partner. See the instructions for Form 1065 for more information.

Form 1065 generally must be filed by April 15 following the close of the partnership's tax year if its accounting period is the calendar year. A fiscal year partnership generally must file its return by the 15th day of the 4th month following the close of its fiscal year. However, if the date for filing a return or making a tax payment falls on a Saturday, Sunday, or legal holiday, the partnership can file the return or make the payment on the next day that is not a Saturday, Sunday, or legal holiday.

If a partnership needs more time to file its partnership return, it should file Form 8736, *Application for Automatic Extension of Time To File Return for a U.S. Partnership, REMIC, or for Certain Trusts*, by the regular due date of its Form 1065. The automatic extension is 3 months.

A ***penalty*** is assessed against the partnership if it is required to file a partnership return and, unless the failure is due to reasonable cause, it fails to file the return on time, including extensions, or fails to file a return that shows all the information required. The penalty is $50 per month (or part of a month) per partner, up to a maximum of 5 months. For more information, see Publication 541, *Tax Information on Partnerships*.

The partnership will also receive a penalty if it fails to provide copies of Schedules K–1 (Form 1065) to the partners, if the failure was due to willful negligence and not reasonable cause.

As a result of partnership distributions, partners may have to make payments of estimated tax, as discussed in Chapter 27.

Income, Deductions, and Allocations

In determining the partner's income tax for the year (on his or her own income tax return), the partner must take into account his or her ***distributive share*** (whether or not it is distributed) of partnership items. These items will be furnished to the partner on Schedule K-1 (Form 1065). See the instructions for Form 1065 for more information.

Treatment of partnership items. Partners must treat partnership items in the same way on their individual tax returns as the items are treated on the partnership return. If a partner treats an item differently on his or her individual return, the IRS can automatically assess and collect any tax and penalties that result from adjusting the item to make its treatment consistent with the treatment on the partnership return. However, this does not apply if a partner files Form 8082, *Notice of Inconsistent Treatment or Amended Return*, with his or her return identifying the different treatment.

Examination procedures. Under current examination procedures, the tax treatment of any partnership item is determined at the partnership level in a unified partnership proceeding rather than at the individual partner's level. After the proper treatment of a partnership item is determined at the partnership level, the IRS can automatically make related adjustments to the tax returns of the partners based on the partners' shares of any adjusted items.

These examination procedures do not apply to partnerships that have no more than 10 partners who are individuals (but only if no partner is a nonresident alien) or estates if each partner's share of every partnership item is the same as that partner's share of every other item. However, these small partnerships can make an election to have these procedures apply.

For more information on these procedures, see Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

Tax preference income. To figure alternative minimum tax, a partner must separately take into account any distributive share of items of income and deductions that enter into the computation of alternative minimum taxable income. For additional information, see Publication 909, *Alternative Minimum Tax for Individuals*.

Distributive share. Generally, a partner's distributive share of any item or kind of income, gain, loss, deduction, or credit is determined by the partnership agreement.

A partner's distributive share of each item will be determined by his or her interest in the partnership (determined by taking into account all the facts and circumstances) if either of the following applies.

1) The partnership agreement does not provide for each distributive share of income, gain, loss, deduction, or credit (or item thereof).
2) The allocation of income, gain, loss, deduction, or credit (or item thereof) to any partner under the agreement does not have substantial economic effect.

Substantial economic effect. An allocation has substantial economic effect if both of the following apply.

1) The allocation actually affects the dollar amount of the partners' shares of partnership income or loss independently of tax consequences.
2) The partner to whom an allocation is made actually receives the economic benefit or bears the economic burden that corresponds to that allocation.

If an allocation made by the partnership is set aside, a partner's share of any item will be determined by his or her interest in the partnership. This is done by taking into account the interests of all partners in profits and losses (if different from that of taxable income or loss), cash flow, and the rights of the partners to distributions of capital upon liquidation.

Character of items. Generally, the character of any item of income, gain, loss, deduction, or credit is determined as if the partner realized it directly from the same source from which it was realized by the partnership or as if it were incurred in the same manner as it was incurred by the partnership.

For example, a partner's distributive share of gain from the sale of partnership depreciable property used in a trade or business of the partnership is treated as if it were gain from the sale of depreciable property that the partner used in a trade or business.

Self-employment tax. A partner's distributive share of income from a partnership is usually included in figuring net earnings from self-employment. If an individual partner has net earnings from self-employment of $400 or more for the year, the partner must figure self-employment tax on Schedule SE (Form 1040). See Chapter 32.

Gross income. When it is necessary to determine the gross income of a partner, the partner's gross income includes his or her distributive share of the partnership's gross income. For example, each partner's share of partnership gross income is used in determining whether an income tax return must be filed by that individual partner.

Actual distributions. Distributions by the partnership generally are not taxable since a partner must include in income any share of partnership income, whether it is distributed or not. However, distributions are taxable if they are treated as a liquidation or as a sale or exchange of all or part of a partner's capital interest.

Losses

A partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of the partner's interest in the partnership. The adjusted basis is figured at the end of the partnership's tax year in which the loss occurred, before taking the loss into account. Any loss that is more than the partner's adjusted basis will be allowed (up to the partner's basis) as a deduction at the end of the year in which the partner increases his or her basis to more than zero. The partner's adjusted basis can never be less than zero. Basis generally includes the partner's prorated share of partnership liabilities. See *Basis of Partner's Interest*, later.

Example. Joe and Bob do business as a partnership. They file their partnership and individual returns on a calendar year basis. The partnership lost $10,000 during last year. Joe's distributive share of the loss is $5,000. The adjusted basis of his partnership interest, before considering his share of last year's loss, was $2,000. He could claim only $2,000 of the loss on his last year's individual return. The adjusted basis of his interest at the end of last year was then reduced to zero.

The partnership showed an $8,000 profit for this year. Joe's $4,000 share of the profit increased the adjusted basis of his interest by $4,000 (not taking into account the $3,000 excess loss he could not deduct last year). His return for this year will show his $4,000 distributive share of this year's profits and the $3,000 loss not allowable last year. The adjusted basis of his partnership interest at the end of this year is $1,000.

At-risk loss limits. At-risk rules apply to most trade or business activities, including activities conducted through a partnership, or activities for the production of income. The at-risk rules limit the amount of loss a partner can deduct to the amounts for which that partner is considered at risk in the activity.

A partner is considered at risk for the amount of cash and the adjusted basis of property contributed to the activity, income retained by the partnership, and certain amounts borrowed by the partnership for use in the activity. However, a partner generally is not considered at risk for amounts borrowed unless that partner is personally liable for the repayment or the amounts borrowed are secured by the partner's property other than property used in the activity.

A partner is not considered at risk for amounts which are protected against loss through guarantees, stop-loss agreements, or other similar arrangements. The partner is also not at risk for amounts borrowed if the lender has an interest in the activity (other than as a creditor) or if the lender is related to a person (other than the partner) having an interest. For more information on determining the amount at risk, see Publication 925, *Passive Activity and At–Risk Rules*.

Passive activities. In general, section 469 limits the amount of losses, deductions, and credits that partners can claim from "passive activities." The passive activity limits do not apply to the partnership. Instead, they apply to each partner's share of any income or loss and credit from passive activities. Because the treatment of each partner's share of partnership income or loss and credit depends upon the nature of the activity that generated it, the partnership must report income or loss and credits separately for each activity.

Generally, passive activities include activities that involve the conduct of a trade or business, if the partner does not materially participate in the activity, and all rental activities, regardless of the partner's participation. The level of each partner's participation in an activity must be determined by the partner. For more information on passive activities, see Publication 925.

Limited partners generally are not considered to materially participate in trade or business activities conducted through partnerships.

Depreciation of Contributed Property

Generally, the partnership's basis for determining depreciation, depletion, gain, or loss on property contributed by a partner is the same as the partner's adjusted basis of the property when it was contributed.

The fair market value of property at the time it is contributed may be different from the partner's adjusted basis. The partnership must allocate any income, deduction, gain, or loss on the property among the partners in a manner that will account for all or any part of the difference.

However, the amount allocated to a partner cannot be more than the total of the amount allowable to the partnership for tax purposes. The allocation can apply to all property contributed or only to specific items.

Example. Sara contributed $10,000 in cash to a partnership, and Gail contributed depreciable property with a fair market value of $10,000 and an adjusted basis of $4,000. The partnership's basis for depreciation is limited to the adjusted basis in Gail's hands, $4,000.

The entire yearly depreciation can be allocated to Sara who contributed the cash. In effect, Sara purchased an undivided one-half interest in the depreciable property with her contribution of $10,000. Assuming that the depreciation rate is 10% a year under the alternate modified accelerated cost recovery system, Sara would have been entitled to a depreciation deduction of $500 per year.

However, since the partnership is allowed only $400 per year of depreciation (10% of $4000), no more than $400 can be allocated between the partners.

Family Partnerships

A family partnership is one in which the members are closely related through blood or marriage.

Family member as a partner. Family members will be recognized as partners only if one of the following requirements is met.

1) If capital is a material income-producing factor, they must acquire their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own the partnership interest, and actually have control over the interest.
2) If capital is not a material income-producing factor, they must contribute substantial or vital services to the partnership.

Capital ***is a material income-producing factor*** if a substantial part of the gross income of the business comes from the use of capital, as when substantial inventories or investments in plant, machinery, or equipment are required.

Capital ***is not a material income-producing factor*** if the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.

Capital interest. A capital interest in a partnership is an interest in its assets that is distributable to the owner of the interest if he or she withdraws from the partnership or if the partnership liquidates. The mere right to share in the earnings and profits is not a capital interest in the partnership.

If a family member receives a gift of a capital interest in a family partnership in which capital is a material income-producing factor, there are limits on the amount that can be allocated to that member (donee) as a distributive share of partnership income.

Purchase of capital interest. An interest purchased by one member of a family from another member of the family is considered to be created by gift. Family includes only spouses, ancestors, and lineal descendants, or any trusts for their benefit. Brothers and sisters are not included.

The donor of the interest must be allocated an amount of partnership income that represents reasonable compensation for the donor's services to the partnership. The remaining income generally is divided among the partners according to their agreement for sharing partnership profits and losses. However, the part of the remaining income allocated to the donee cannot be proportionately greater than the income allocated to the capital interest of the donor.

Example. A father sold 50% of his business to his son. The resulting partnership had a profit of $60,000. Capital is a material income-producing factor. The father performed services worth $24,000, which is reasonable compensation, and the son performed no services. The $24,000 must be allocated to the father as compensation. Of the remaining $36,000 of income which is due to capital, at least 50%, or $18,000, must be allocated to the father since he owns a 50% capital interest. The son's share of partnership income cannot be more than $18,000.

Partner's Dealings with the Partnership

For certain transactions between a partner and his or her partnership, the partner is treated as not being a member of the partnership.

Sales and exchanges. Special rules apply to sales or exchanges of property between certain persons and partnerships.

Losses. Losses will not be allowed from a sale or exchange of property (other than an interest in the partnership) directly or indirectly between a partnership and a person whose direct or indirect interest in the capital or profits of the partnership is ***more than 50%.***

If the sale or exchange is between two partnerships in which the same persons directly or indirectly own a more than 50% interest of the capital or profits in each, no loss deduction is allowed.

In either case, if the purchaser later sells the property, any gain realized will be taxable only to the extent that it is more than the loss that was not allowed.

Gains. Gains are treated as ordinary income in a sale or exchange of property directly or indirectly between a person and a partnership, or between two partnerships, if both of the following apply.

1) More than 50% of the capital or profits interest in the partnership(s) is directly or indirectly owned by the same person(s).
2) The property in the hands of the transferee immediately after the transfer is not a capital asset. Property that is ***not a capital asset*** includes trade accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

Determining ownership. Determination of the more than 50% ownership in partnership capital or profits is made by applying the following rules.

1) An interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries.
2) An individual is considered to own the interest that is directly or indirectly owned by or for the individual's family (includes only brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants).
3) If a person is considered to own an interest using rule (1), that person (the "constructive owner") is treated as if actually owning that interest when rules (1) and (2) are applied. However, if a person is considered to own an interest using rule (2), that person is not treated as actually owning that interest so as to make another person the constructive owner.

Example. Individuals A and B and Trust T are equal partners in Partnership ABT. A's husband, AH, is the sole beneficiary of Trust T. Trust T's partnership interest will be attributed to AH only for the purpose of further attributing the interest to A. This attribution makes A a more-than-50% partner. This means that losses on transactions between her and ABT will be disallowed, and any gains will be treated as ordinary rather than capital gains.

Payments by accrual basis partnership to cash basis partner. A partnership that uses an accrual method of accounting cannot deduct any business expense owed to a cash basis partner until the amounts are paid, and the partner includes the payment in income. This does not apply to guaranteed payments made to a partner which generally are deductible when accrued.

Guaranteed payments. A partnership treats guaranteed payments to a partner for services, or for the use of capital, as if they were made to a person who is not a partner, but only if the payments are figured without regard to the partnership's income. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Also, guaranteed payments are not subject to tax withholding as payments to partnership employees are.

The payments generally are deductible by the partnership as a business expense. They are included in Schedules K and K–1 of the partnership return and are reported by the individual partner on Form 1040 as ordinary income, in addition to the appropriate distributive share of the other ordinary income of the partnership.

Guaranteed payments made to partners for organizing the partnership or syndicating interests in the partnership are capital expenditures and are not deductible by the partnership. However, the payments must be included in the partner's tax return. See *Organizational costs for a partnership* in Chapter 13.

A partner includes the guaranteed payments in income in the partner's tax year in which the partnership's tax year ends.

Example. Under the terms of the partnership agreement, Erica is entitled to a fixed annual payment of $10,000 without regard to the income of the partnership. Erica's distributive share of the partnership income is 10%. After deducting the guaranteed payment, the partnership has $50,000 of ordinary income. She must include $15,000 as ordinary income in her income tax return for her tax year in which the partnership tax year ends ($10,000 guaranteed payment plus $5,000 ($50,000 × 10%) distributive share).

Guaranteed minimum. If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's share of the partnership income ***before*** taking into account the minimum payment.

Example. Under a partnership agreement, Chris is to receive 30% of the partnership income, but not less than $8,000. The partnership has net income of $20,000. Chris's share, without regard to the minimum guarantee, is $6,000 (30% of $20,000). Thus, the amount of the guaranteed payment that may be deducted by the partnership is $2,000 ($8,000 less $6,000). Chris's income from the partnership is $8,000, and the remaining $12,000 will be reported by the other partners in proportion to their shares under the partnership agreement. If the partnership net income had been $30,000, there would have been no guaranteed payment since his share, without regard to the guarantee, would have been greater than the guarantee.

Payments resulting in loss. Assume that a partnership agreement provided for guaranteed payments to a partner. The guaranteed payments during the year resulted in a partnership loss in which the partner shared. That partner must report the full amount of the guaranteed payments as ordinary income and must separately take into account the appropriate distributive share of the partnership loss.

Contributed Property

Usually, neither the partners nor the partnership recognizes a gain or loss when property is contributed to the partnership in exchange for a partnership interest. This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period.

However, a transaction is treated as an exchange of property on which gain or loss is recognized if a partner contributes property to a partnership and within a short period:

1) Before or after the contribution, other property is distributed to the contributing partner and the contributed property is kept by the partnership, or
2) After the contribution, the contributed property is distributed to another partner.

Special rule for investment companies. Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated. A loss realized on a contribution of stock, securities, or other property is not recognized. For more information, see Publication 541.

Interest acquired as compensation. A partner can acquire an interest in partnership capital as compensation for services performed or to be performed. The fair market value of such an interest generally must be included in the partner's gross income in the first tax year in which the partner's interest can be transferred or is not subject to a substantial risk of forfeiture. Such a transfer of a partnership interest as compensation for services is subject to the rules discussed under *Pay in the form of restricted property* in Chapter 10.

Partnership's gain or loss on contributed property. For unrealized receivables, inventory items, and certain capital loss property contributed by a partner to a partnership after March 31, 1984, the character of the gain or loss to the partnership on a later disposition is determined by special rules discussed in Publication 541.

Basis of Partner's Interest

The adjusted basis of a partnership interest is ordinarily figured at the end of a partnership's tax year. However, if there has been a sale or exchange of all or a part of the partner's interest or a liquidation of his or her entire interest in a partnership, the adjusted basis is figured on the date of the sale, exchange, or liquidation.

Book value of interest. The adjusted basis of a partner's interest is determined without considering any amount shown in the partnership books as a capital, equity, or similar account.

Example. Sam contributes property that has an adjusted basis of $400 and a fair market value of $1,000 to a partnership. His partner contributes $1,000 cash. While under the partnership agreement each has a capital account in the partnership of $1,000, which will be reflected in the partnership books, the adjusted basis of Sam's interest is only $400 and his partner's basis is $1,000.

Original basis. The original basis of a partnership interest is the money a partner contributed plus the adjusted basis of any property he or she contributed. If the property contribution results in taxable income to the partner, the income generally will be included in the basis of his or her interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is also treated as a contribution of money by the partner to the partnership.

If the property contributed is subject to indebtedness or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced by the liability that is assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner. This assumption by the other partners of the liability is treated as though they had made a contribution of money to the partnership.

Example 1. John acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of $8,000 and a $4,000 mortgage. The partnership assumed payment of the mortgage. The adjusted basis of John's interest is:

Adjusted basis of the property contributed	$8,000
Minus: Part of mortgage assumed by his partners that must be treated as a distribution of money to him (80% of $4,000)	3,200
Basis of John's partnership interest	$4,800

Example 2. If, in the above example, the property John contributed had a $12,000 mortgage, the adjusted basis of his partnership interest would be zero. The difference between the amount of the mortgage assumed by the other partners, $9,600 (80% × $12,000), and John's basis of $8,000 would be treated as a gain to him from the sale or exchange of a capital asset. However, this gain ***would not*** increase the basis of John's partnership interest.

Basis of interests acquired by gift, etc. If a partner acquires an interest in a partnership by gift, inheritance, or under any circumstance other than by a contribution of money or property to the partnership, the partner's basis must be determined using the basis rules described in Publication 551, *Basis of Assets*.

Adjustments to basis. The original basis of an interest is ***increased*** by:

1) Additional contributions to the partnership,
2) The partner's distributive share of both taxable and nontaxable partnership income, and
3) The excess of the deductions for depletion over the basis of the depletable property.

The original basis is ***decreased*** (but never below zero) by:

1) The amount of money and the adjusted basis of property distributed to the partner by the partnership,
2) The partner's distributive share of partnership losses (including capital losses),
3) Nondeductible partnership expenses that are not capital expenditures,
4) The amount of any deduction for depletion for oil and gas wells, and
5) The partner's share of any section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual tax return. Section 179 allows a deduction of up to $10,000 for the cost of depreciable property placed in service during the year.

Partnership liabilities. If the liabilities of a partnership are ***increased,*** resulting in an increase in a partner's share of the liabilities, this increase is treated as a contribution of money by the partner to the partnership.

If the liabilities of a partnership are ***decreased,*** resulting in a decrease in a partner's share of the liabilities, this decrease is treated as a distribution of money to the partner by the partnership.

Example 1. Carol and Sue are equal partners and their partnership borrows $1,000. The basis of the partnership interest of each ***is increased*** by $500 since each is considered to have contributed that amount to the partnership. Partners increase their basis regardless of the partnership's method of accounting.

Example 2. Carl and Bill are equal partners and their partnership repays a $10,000 note. The basis of the partnership interest of each ***is decreased*** by $5,000 since each is considered to have received a distribution of that amount from the partnership.

For more information on liabilities, see Publication 541.

Alternative rule. In certain cases, the adjusted basis of a partnership interest can be figured by using the partner's share of the adjusted basis of partnership property that would be distributable to the partner if the partnership terminated.

This alternative rule can be used to determine the adjusted basis of a partner's interest if either of the following applies.

1) The circumstances are such that the partner cannot practicably apply the general basis rules.
2) It is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result under the general basis rules.

Adjustments may be necessary in figuring a partner's adjusted basis of a partnership interest under the alternative rule. For example, adjustments would be required to include in the partner's share of the adjusted basis of partnership property any significant discrepancies that resulted from contributed property, transfers of partnership interests, or distributions of property to the partners.

Partner's Basis of Property Received

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

Example 1. The adjusted basis of Betty's partnership interest is $30,000. She receives a distribution of property that has an adjusted basis of $20,000 to the partnership and $4,000 in cash. Her basis for the property is $20,000.

Example 2. The adjusted basis of Mike's partnership interest is $10,000. He receives a distribution of $4,000 cash and property that has an adjusted basis to the partnership of $8,000. His basis for the distributed property is limited to $6,000 ($10,000 minus the $4,000 cash he receives).

Holding period for distributed property. A partner's holding period for property distributed to the partner by the partnership includes the period that the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included. However, this does not apply for determining the holding period for substantially appreciated inventory items (defined later).

Complete liquidation of partner's interest. The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership, reduced by any money distributed to the partner in the same transaction.

Special rule. When a partnership distributes—

1) Unrealized receivables or substantially appreciated inventory items to a partner in exchange for any part of the partner's interest in other partnership property, including money, or
2) Other property (including money) in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items,

the distribution is treated as a sale or exchange of property that is not a capital asset. See *Unrealized Receivables and Inventory Items,* later.

Exceptions. The special rule does not apply in the following situations:

1) A distribution of property to the partner that had contributed the property to the partnership,
2) Certain payments made to a retiring partner or successor in interest of a deceased partner, and
3) A distribution to the extent that it consists of the partner's share of the unrealized receivables, inventory items, or other property.

Basis divided among properties. Generally, the basis of property received is limited to the adjusted basis of the partner's interest in the partnership, reduced by money received in the same transaction. This basis must be divided among the properties distributed to a partner. The basis must first be allocated to unrealized receivables and inventory items included in the distribution.

The receivables or inventory items generally cannot take a higher basis in the partner's hands than their common adjusted basis to the partnership immediately before the distribution. However, the items could have a higher basis if the distribution is treated as a sale or exchange under the *Special rule,* discussed earlier.

The remaining basis must then be divided among any other properties distributed to the partner in the same transaction. The division must be in proportion to their adjusted bases in the hands of the partnership before the distribution.

Example. The adjusted basis of Ted's partnership interest is $30,000. In complete liquidation of his interest, Ted receives $10,000 in cash, his share of inventory items having a basis to the partnership of $12,000, and two parcels of land having adjusted bases to the partnership of $12,000 and $4,000.

The basis of Ted's partnership interest is reduced to $20,000 by the $10,000 cash. This $20,000 basis is then divided among the properties he receives. The inventory items in his hands now have a basis of $12,000. To divide the balance of $8,000, Ted adds the bases of the land ($12,000 and $4,000), and takes 12,000/16,000 of $8,000 and 4,000/16,000 of $8,000. The bases of the two parcels of land in his hands are $6,000 and $2,000, respectively.

Partner's interest less than partnership basis. If the partnership's adjusted basis for the unrealized receivables and inventory items distributed to a partner is more than the adjusted basis of the partner's interest, the amount of the partner's basis is allocated among these items in proportion to the partnership's adjusted bases of the items. The partner's basis must be reduced first by any money distributed in the same transaction.

Example. Jenny's basis for her partnership interest is $18,000. In a distribution in liquidation of her entire interest, she receives $12,000 cash, her share of inventory items having an adjusted basis to the partnership of $12,000, and unrealized receivables having a basis to the partnership of $8,000. The basis of her partnership interest is first reduced to $6,000 by the $12,000 cash she receives. This $6,000 basis is then divided proportionately between the inventory items and the unrealized receivables. Jenny's basis for the inventory items is $3,600 (12,000/20,000 of $6,000). Her basis for the unrealized receivables is $2,400 (8,000/20,000 of $6,000).

Partner's interest more than partnership basis. If the basis of a partner's interest to be divided is more than the partnership's adjusted basis for the unrealized receivables and inventory items distributed, and if no other property is distributed to which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest. See Chapter 22 for a discussion of capital losses.

Special adjustment to basis of property received. There is a special rule for figuring the partnership basis of property (other than money) distributed to a partner within 2 years after the partner acquires his or her partnership interest through a sale or exchange or upon the death of a partner. See Publication 541.

Partnership Basis of Property Retained

Generally, a partnership cannot adjust the basis of its property because of a distribution of property to a partner or because of a transfer of an interest in the partnership, whether by a sale or exchange or because of the death of a partner. The partnership can adjust the basis only if it specifically chooses to make an optional adjustment to the basis of its property upon the transfer. A partnership does not adjust the basis of partnership property for a contribution of property, including money, to the partnership. See Publication 541 for more information.

Sales, Exchanges, and Other Transfers

The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. If the selling partner is relieved of any liabilities of the partnership, the selling partner must include the liabilities to determine the amount realized for his or her interest.

Example 1. Fred became a limited partner in the ABC Partnership by contributing $10,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of the current year is $20,000, which includes his share of partnership liabilities of $15,000. The partnership has no other liabilities and no unrealized receivables or substantially appreciated inventory items. Fred sells his interest in the partnership for $10,000 in cash. He had been paid his share of the partnership income for the tax year.

The amount realized by Fred from the sale of his partnership interest is $25,000, consisting of the $10,000 cash payment and the amount of his share of partnership liabilities of which he is relieved, $15,000. Since the adjusted basis of his interest in the partnership is $20,000, he realizes a gain of $5,000, which he reports as a capital gain.

Example 2. The facts are the same as in Example 1, except that instead of selling his interest, Fred withdraws from the partnership at a time when the adjusted basis of his interest in the partnership is zero. In this situation he is considered to have received a distribution of money from the partnership of $15,000, the amount of liabilities of which he is relieved. Since the partnership has no unrealized receivables or substantially appreciated inventory items, Fred reports a capital gain of $15,000.

Exchange of interest in one partnership for interest in another. Generally, exchanges of partnership interests do not qualify as nontaxable exchanges of like-kind property. However, under some circumstances, such an exchange may be treated as a tax-free contribution of property to a partnership. See Publication 541.

Liquidation of Partner's Interest

When payments are made by the partnership to a retiring partner or to a successor in interest of a deceased partner in return for the partner's entire interest in the partnership, the payments may have to be allocated between payments in liquidation and other payments.

For income tax purposes, a retired partner or a successor in interest to a deceased partner is treated as a partner until his or her interest in the partnership has been completely liquidated.

Payments in liquidation. Payments in liquidation of a partner's entire interest, to the extent that they are made in exchange for the interest in partnership property, are treated as distributions to the partner by the partnership. Amounts paid for ***unrealized receivables,*** discussed later, or for ***goodwill*** are not treated as distributions unless the partnership agreement provides for payments for goodwill. See *Other payments.*

Generally, the partners' valuation of a partner's interest in partnership property in an arm's-length agreement will be treated as correct. If the valuation reflects only the partner's net interest in the property (total assets less liabilities), it must be adjusted so that both the value of and the basis for the partner's interest include the partner's share of partnership liabilities.

Other payments. Payments in liquidation of an interest that are not made in exchange for the interest in partnership property are treated either as ***distributive shares*** of partnership income or as ***guaranteed payments*** regardless of the time over which the payments are to be made.

If the amount is based on partnership income, the payments are taxable as distributive shares of partnership income. If the amount is not based on partnership income, it is treated as a guaranteed payment. In either case, the payments are treated as ordinary income by the recipient.

These payments are included in income by the recipient for his or her tax year that includes the end of the partnership tax year for which the payments are a distributive share or in which the partnership is entitled to deduct them as guaranteed payments.

The ***remaining partners' distributive shares*** are reduced by payments in exchange for a retired or deceased partner's interest when those payments are treated as distributive shares of partnership income or guaranteed payments.

Guaranteed periodic payments to satisfy a partnership's liability to a previously retired partner that are continued by the former remaining partners after they terminate the partnership are deductible by them as business expenses in the year paid.

Partner's taxable income. If a partner disposes of his or her ***entire interest*** in a partnership, the partner must include his or her distributive share of partnership items in taxable income for the tax year in which membership in the partnership ends. To compute the distributive share of these items, the partnership's tax year is considered ended on the date that the partner disposed of the interest. To avoid an interim closing of the partnership books, the partners can agree that the distributive share can be estimated by taking a prorated amount of the items the partner would have included in income if he or she remained a partner for the entire partnership tax year.

A partner who sells or exchanges only ***part of an interest*** in a partnership, or whose interest is changed (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise), reports his or her distributive share of partnership items by taking into account his or her varying interests during the partnership year.

Deceased partner. If a partner dies, the partner's estate or other successor in interest reports in its return the decedent's distributive share of the partnership items for the partnership tax year ending after the death occurred.

For example, if the partnership and the partners all use a calendar year as their tax year and one of the partners dies on June 10, none of the income of the partnership for that year will be reported in the final return of the deceased partner. All of it will be included in the return of the partner's estate or other successor in interest.

However, if the partnership year terminates with the death of the partner, the deceased partner's share of income for that year will be

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included in the deceased partner's final return. If the decedent's tax year is different from the partnership's, the decedent's final return will include his or her share of partnership items for both the partnership year ending with the decedent's death and any partnership year ending earlier in the decedent's last tax year. See Publication 541 for more information.

Unrealized Receivables and Inventory Items

If a partner receives money or property in exchange for any part of a partnership interest, the amount that is due to his or her share of the inventory items of the partnership that have appreciated substantially in value and the partnership's unrealized receivables results in ordinary income or loss. Any amount received is treated as if it were received for the sale or exchange of property that is not a capital asset.

Unrealized receivables. Unrealized receivables are any rights to payment that have not already been included in income for goods delivered or to be delivered to the extent that the payment would be treated as received for property other than a capital asset, or for services performed or to be performed.

These rights must have arisen under contracts or agreements that existed at the time of sale or distribution, even though the partnership may not be able to enforce payment until a later date. For example, unrealized receivables include trade accounts receivable of a cash method partnership and rights to payment for work or goods begun but incomplete at the time of the sale or distribution of the partnership share.

The basis for any unrealized receivables includes all costs or expenses for the receivables that were paid or accrued but not previously taken into account under the partnership's method of accounting.

Unrealized receivables include the gain that would be treated as ordinary income if the partnership had sold certain depreciable property at its fair market value at the time that any of the following partnership transactions occur.

1) A distribution by a partnership to a partner,
2) A payment made in liquidation of an interest of a retiring partner or deceased partner, or
3) A sale or exchange of an interest in a partnership by a partner.

Unrealized receivables also include the amount of potential gain that would be ordinary income from:

1) Mining property,
2) Stock in an Interest Charge Domestic International Sales Corporation (IC–DISC),
3) Certain farmland expenses for soil and water conservation or land clearing,
4) Franchises, trademarks, or trade names,
5) Oil, gas, or geothermal property,
6) Stock of certain controlled foreign corporations, and
7) Market discount bonds and short-term obligations.

See Publication 541 for more information.

Inventory items that have appreciated substantially in value. Inventory items of the partnership are considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items is more than:

1) 120% of the partnership's adjusted basis of this property, and
2) 10% of the fair market value of all partnership property, other than money.

Inventory items are not just stock-in-trade of the partnership. They include any property that is part of inventory on hand at the end of the tax year or that is held primarily for sale to customers in the normal course of business. They include any asset that is not a capital asset or is not treated as a capital asset. They also include any other property held by the partnership that would be considered inventory items if held by the selling or distributee partner.

See Publication 541 for more information.

29. Corporations

Important Changes for 1990

Reduction in basis of stock. For stock issued after July 10, 1989, the rules on an extraordinary dividend received on a share of stock will now apply to a dividend on disqualified preferred stock without regard to the period the corporation held the stock.

These rules apply to stock issued after July 10, 1989, unless issued under a written binding contract in effect on that date.

Interest paid to related tax-exempt parties. For tax years beginning after July 10, 1989, a deduction for certain interest paid by a corporation to related parties not subject to tax on the interest received is not allowed. The amount of disallowed interest is carried to subsequent years.

This chapter explains the application of various tax provisions to corporations, including filing requirements, tax computations, estimated tax payments, corporate distributions, and retained earnings.

Certain areas of corporation taxation are not covered in this publication. For a more complete discussion of corporation taxation, as well as liquidations and stock redemptions, please get Publication 542, *Tax Information on Corporations.*

Special Provisions

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, a corporation is entitled to certain ***special deductions*** in figuring its taxable income.

Dividends-Received Deduction

A corporation is allowed a deduction for a percentage of certain dividends received during its tax year.

Dividends from domestic corporations. A corporation may deduct, subject to certain limitations, 70% of the dividends received if the corporation receiving the dividend owns less than 20% of the distributing corporation. Dividends on certain preferred stock of public utility companies (mentioned later), and certain dividends of Federal Home Loan Banks are treated differently. The dividends must be distributions from the earnings and profits of the paying corporation. This rule applies if the corporation owns less than 20% of the paying domestic corporation.

20%-or-more owners allowed 80% deduction. A corporation can take a deduction for 80% of the dividends received or accrued if it owns 20% or more of the paying domestic corporation. This corporation is referred to as a ***20%-owned corporation.***

Ownership. Ownership, for purposes of these rules, is determined by the amount of voting power and value of stock (other than certain preferred stock) the corporation owns.

Capital gain dividends. Capital gain dividends from a regulated investment company or real estate investment trust, and distributions that are a return of capital do not qualify. So-called dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are treated as interest and do not qualify for this deduction.

Small business investment companies. Small business investment companies may deduct 100% of the dividends received from a taxable domestic corporation.

Affiliated corporations. Members of an affiliated group of corporations may elect, if certain conditions are met, to deduct 100% of the dividends received from a member of the same affiliated group. See section 243 of the Internal Revenue Code for further information.

Regulated investment company. Regulated investment company dividends received are subject to certain limitations.

Dividends received on certain preferred stock. Your corporation may deduct 41.176% of the dividends it receives on certain preferred stock (issued before October 1942) of a taxable public utility. For more information, see section 244 of the Internal Revenue Code

Dividends received from foreign corporations. A corporation may deduct a percentage of the dividends it receives from 10%-owned foreign corporations. For more information, see section 245 of the Internal Revenue Code.

No deduction is allowed. No deduction is allowed for dividends received from:

A real estate investment trust,

A corporation exempt from tax either for the tax year of the distribution or the preceding tax year,

A corporation whose stock has been held by your corporation for 45 days or less. A corporation whose stock has been held by your corporation for 90 days or less if the stock has preference as to dividends and the dividends received on it are attributable to a period or periods totaling more than 366 days, or

Any corporation, to the extent your corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Limit on deduction for dividends. Generally, the total deduction for dividends received or accrued is limited (in the following order) to:

1) 80% of the difference between taxable income and the 100% deduction for dividends received from affiliated corporations, for dividends received or accrued from 20%-owned corporations, and
2) 70% of the difference between taxable income and the 100% deduction for dividends received from affiliated corporations, for dividends received or accrued from less than 20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

Figuring limit. In figuring this limit, taxable income is determined without allowance of the net operating loss deduction or deduction for dividends received (without the deduction for dividends paid on certain preferred stock of a public utility), and without deduction for the nontaxable portion of an extraordinary dividend. Taxable income is also determined without regard to any capital loss carryback to the tax year.

Effect of net operating loss. If your corporation sustains a net operating loss (defined in Chapter 20) for a tax year, the limitation of 80% (or 70%) of taxable income does not apply. To determine whether or not a corporation has a net operating loss, the dividends-received deduction is figured without regard to the 80% (or 70%) of taxable income limitation.

Example 1. A corporation loses $25,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Therefore, its taxable income is $75,000 before the deduction for dividends received. However, if it claims the full dividends-received deduction of $80,000 ($100,000 × 80%) and combines it with the operations loss of $25,000, it will have a net operating loss of $5,000. Therefore, the 80% of taxable income limitation does not apply and the corporation is entitled to a full deduction of $80,000.

Example 2. Assume the same facts as in Example 1 except that the corporation loses $15,000 from operations. Therefore, its taxable income is $85,000 before the deduction for dividends received. However, after claiming the dividends-received deduction of $80,000 ($100,000 × 80%), its taxable income is $5,000. But because the corporation will not have a net-operating loss after a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or $68,000 ($85,000 × 80%).

Dividends received in property. When a corporation receives a dividend from another domestic corporation in the form of property other than cash, the dividend is included in income in an amount equal to the ***lesser*** of the property's fair market value, ***or*** the adjusted basis of the property in the hands of the distributing corporation increased by the amount of any gain recognized by the distributing corporation on the distribution.

Dividends received on debt-financed portfolio stock. For dividends received on debt-financed portfolio stock of domestic corporations, the 70% (80% for any dividend received from a 20%-owned corporation) dividend-received deduction is reduced by a percentage related to the amount of debt incurred to purchase the stock. This applies to stock whose holding period begins after July 18, 1984. For more information, see section 246A of the Internal Revenue Code.

Basis reduction for extraordinary dividends. If a corporation receives an extraordinary dividend on a share of stock, and the corporation has not held the stock for more than 2 years before the dividend announcement date, the corporation's basis in the stock is reduced (but not below zero) by the nontaxed portion of the dividend. The total of nontaxed portions of dividends on a share of stock that did not reduce the basis of the stock, due to the limitation on reducing basis below zero, is treated as gain from the sale or exchange of the stock.

An ***extraordinary dividend*** is any dividend on a share of stock that equals or exceeds (1) 5% for stock that is preferred as to dividends, or (2) 10% for other stock of the corporation's adjusted basis in the share of stock. All dividends received that have ex-dividend dates within an 85-consecutive day period are treated as one dividend. All dividends received that have ex-dividend dates within a 365 consecutive-day period are treated as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock. Qualifying dividends, discussed earlier under *Affiliated corporations,* are not included in the definition of extraordinary dividends.

If a corporation establishes, to the satisfaction of the IRS, the fair market value of a share of stock as of the day before the ex-dividend date, the corporation may elect to determine whether the dividend is extraordinary by using the fair market value of the stock rather than its adjusted basis. (See Revenue Procedure 87–33 in the 1987–2 C.B. 402.)

The ***nontaxed portion*** is the amount of any dividends-received deduction allowable on such dividends.

The ***dividend announcement date*** is the date the corporation declares, announces, or agrees to either the amount or the payment of the dividend, whichever is earlier.

Stock issued after July 10, 1989. The rules apply to an extraordinary dividend on disqualified preferred stock issued after July 10, 1989, without regard to the period the corporation held the stock.

Disqualified preferred stock. Disqualified preferred stock is any stock that is preferred as to dividends if:

1) The stock when issued has a dividend rate that declines (or can reasonably be expected to decline) in the future,
2) The issue price of the stock exceeds its liquidation rights or stated redemption price, or
3) The stock is otherwise structured to avoid the rules for extraordinary dividends and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock.

These rules apply to stock issued after July 10, 1989, unless issued under a written binding contract in effect on that date and thereafter before the stock is issued.

Charitable Contributions

A corporation may claim a deduction, subject to certain limits, for any charitable contributions made in cash or other property. To be deductible, the contribution generally must be made to or for the use of community chests, funds, foundations, corporations, or trusts, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, or other charitable organizations.

A deduction will not be allowed if any of the net earnings of an organization that receives the contribution are used for the benefit of any private shareholder or individual.

The organization to which you make a contribution should be able to tell you if the contribution is deductible.

Cash method corporation. A corporation using the cash method of accounting may deduct contributions only in the year paid.

Accrual method corporation. A corporation using the accrual method of accounting may choose to deduct contributions authorized by the board of directors but not paid during the tax year, if payment is made within 2½ months after the close of the tax year. The choice must be made by reporting the contribution on the corporation return for the tax year. The return must be accompanied by a declaration stating that the resolution authorizing the contribution was adopted by the board of directors during the tax year for which the return is filed. This declaration must be signed by the president or some other principal officer.

Limit. Your corporation is not allowed to deduct contributions that are more than 10% of its taxable income. Taxable income for this purpose is figured without taking into account any of the following:

Deduction for contributions,

Deduction for dividends received and dividends paid,

Any net operating loss carryback to the tax year, and

Any capital loss carryback to the tax year.

Carryover of excess contributions. Any charitable contributions made during the year that are more than the 10% limit may, subject to certain limitations, be carried over to each of the following 5 years. Any excess not used up within that period is lost. Thus, if a corporation has a carryover of excess contributions paid in 1989 and the excess is not completely used up in filing returns for 1990, it may be carried over to 1991, 1992, 1993, and 1994. A carryover of excess contributions is not deducted in the carryover year until after any contributions made in that year have been deducted, subject to the 10% limit. A contributions carryover is not allowed to the extent that it increases a net operating loss carryover in a succeeding tax year.

Related Taxpayers

The related-party rules are provided for transactions between an individual and a corporation controlled by the individual, involving sales or exchanges of property and the deduction of certain unpaid business expenses and interest. Under certain conditions, the IRS may reallocate income and deductions between two or more businesses that are either directly or indirectly controlled by the same interests. These rules are discussed in Chapters 4, 10, 22, and 24.

Complete liquidations. The disallowance of losses from the sale or exchange of property between related parties does not apply either to any loss of a distributing corporation or to any loss of a distributee in the case of a distribution in complete liquidation.

Interest paid to related parties. A deduction for interest paid by a corporation to related parties not subject to tax on the interest received is limited to the extent this interest exceeds 50% of the corporation's pre-net-interest-deduction taxable income. The amount of disallowed interest is carried over to subsequent years.

This interest deduction limitation applies to a corporation that has ***excess interest expense*** and whose ratio of debt to equity as of the tax year exceeds 1.5 to 1.

Excess interest expense. Excess interest expense is the excess of the corporation's net interest expense over the sum of 50% of the corporation's adjusted taxable income plus any ***excess limitation*** carryforward.

Excess limitation. Excess limitation means the excess of 50% of the corporation's adjusted taxable income over the corporation's net interest expense.

If a corporation has an excess limitation for a tax year, that amount becomes an excess limitation carryforward to the first succeeding tax year. When it is not used up in the first tax year, it is carried forward to the second or third succeeding tax year if it is not used up before then.

Not subject to tax on the interest means that the related party is not subject to U. S. income tax on the interest income. For example, the related party may be a foreign parent corporation not subject to U.S. tax.

Figuring the Tax

A corporation (other than a member of a controlled group, discussed later) that files Form 1120–A or Form 1120 figures its tax on taxable income using the following three-bracket graduated rate system:

Taxable Income	Tax Rate
Not over $50,000	15%
Over $50,000 but not over $75,000	25%
Over $75,000	34%

Additional tax. An additional 5% tax, up to $11,750, is imposed on corporate taxable income over $100,000. Corporations with taxable income of at least $335,000 pay a flat rate of 34%.

Controlled group of corporations. A controlled group of corporations is limited to one apportionable $50,000 amount and one $25,000 amount (in that order) in each taxable income bracket below 34%.

Unless the controlled group agrees to a different allocation, the $50,000 and $25,000 (in that order) amount is to be divided equally among all members. For more information, see sections 1561 and 1563 of the Internal Revenue Code.

Attribution rules. In determining whether a corporation is a member of a controlled group of corporations, you must also apply the attribution rules for partnerships, trusts, and estates.

Personal service corporations. The taxable income of a qualified personal service corporation is taxed at a flat rate of 34%. These corporations cannot use the graduated tax rates that apply to other corporations.

A corporation is a ***qualified personal service corporation*** if:

At least 95% of the value of its stock is held by employees, or their estates or beneficiaries, and

Its employees perform services at least 95% of the time in any of the following fields:

- Health,
- Law,
- Engineering,
- Architecture,
- Accounting,
- Actuarial science,
- Performing arts, or
- Consulting.

Credits

The tax liability of a corporation is ***decreased*** by credits, such as:

1) Credit for fuels and lubricants used for certain purposes (see Publication 378, *Fuel Tax Credits and Refunds*),
2) Foreign tax credit (use Form 1118),
3) General business credit,
4) Orphan drug credit (use Form 6765),
5) Possessions tax credit (use Form 5735), and
6) Credit for fuel produced from a nonconventional source.

General business credit. The investment credit, jobs credit, alcohol fuel credit, research credit, and the low-income housing credit are combined into one credit called the "general business credit." These credits are separately figured on the appropriate form:

- Form 3468, *Investment Credit* (also see Chapter 31),
- Form 5884, *Jobs Credit* (also see Chapter 31),
- Form 6478, *Credit for Alcohol Used as Fuel,*
- Form 6765, *Credit for Increasing Research Activities (or for claiming the orphan drug credit)* (also see Chapter 31), and
- Form 8586, *Low-Income Housing Credit* (also see Chapter 31).

Form 3800. If you have, in any year, more than one of these five business credits, or a carryforward or carryback of any of these credits (or a carryforward of an Employee Stock Option credit), complete Form 3800, *General Business Credit,* to figure your general business credit and file it with your tax return. However, if you have only one of these credits and no carrybacks or carryovers, you should not file Form 3800. In that case, you should file the individual tax form relating to the credit.

See the instructions to Form 3800 for more information.

Other Taxes

The tax liability of a corporation is ***increased*** by:

1) Personal holding company tax (attach Schedule PH (Form 1120)),
2) Investment credit recapture (see Chapter 31),
3) Alternative minimum tax (see Chapter 34), and
4) Environmental tax.

Environmental tax. A corporation is liable for a tax equal to 0.12% of the excess of modified alternative minimum taxable income for the year over $2,000,000. This tax will not apply after 1991. This tax also must be considered when determining your 1991 estimated tax.

Modified alternative minimum taxable income. Modified alternative minimum taxable income is alternative minimum taxable income (defined later in Chapter 34 under *Alternative Minimum Tax*) without regard to the alternative tax net operating loss deduction and the deduction for the environmental tax.

Estimated Income Tax

Every corporation whose tax shown on the return (or, if no return is filed, the tax for the year) is expected to be $500 or more is required to make estimated tax payments. A corporation's estimated tax is the amount of its expected tax liability (including alternative minimum tax and environmental tax) less its allowable tax credits.

Time and amount of deposits. If a corporation's estimated tax is $500 or more, its estimated tax payments must be deposited with an authorized financial institution or a Federal Reserve Bank. Each deposit must be accompanied by a federal tax deposit coupon and deposited according to the instructions in the coupon book.

The due date of deposits and the amount of installments to be deposited are determined according to the table below.

The following table indicates the part of a corporation's estimated tax that should be deposited on or before the 15th day of the following months of the corporation's tax year.

Required Installment	Month Due
1st	4th month
2nd	6th month
3rd	9th month
4th	12th month

Example 1. The Penn Corporation is a calendar year taxpayer that first meets the requirements for making estimated tax deposits on March 24 and estimates that its tax will be $40,000. The corporation should pay the estimated tax in four $10,000 installments: on April 15, June 15, September 15, and December 15.

Example 2. The Jones Company has a fiscal year beginning April 1 and ending March 31. It first meets the requirement for making estimated tax deposits on July 1 and estimates its tax to be $12,000. The estimated tax should be paid in the following four $3,000 installments: July 15, on September 15, December 15, and March 15.

Amended estimated tax. If, after figuring and making payments of estimated tax, a corporation determines that its estimated tax is substantially larger or smaller than originally estimated, it should refigure the tax before the next installment to determine the amount of its remaining installment payments.

Example. A calendar year corporation determined that its estimated tax is $20,000. The corporation pays the first two installments on April 15 and June 15 in the amount of $5,000 each (25% of $20,000). On July 1, the corporation discovers that its estimated tax can reasonably be expected to be $40,000. The installments payable on September 15 and December 15 will be $15,000 each, figured as follows:

Refigured estimated tax	$40,000
Less: Prior estimated tax payments made	10,000
Unpaid balance	**$30,000**
Installments payable on September 15, and December 15 (unpaid balance ($30,000) divided by remaining installments (2))	**$15,000**

Penalty

A corporation that fails to pay in full a correct installment of estimated tax by the due date is generally subject to a penalty. The penalty rate is applied to the period of underpayment for any installment. The penalty is figured at a rate of interest published quarterly by the IRS.

Figuring the underpayment. The underpayment of any installment is the amount required to be paid minus the amount paid by the due date of the installment.

The ***amount required to be paid*** is an installment based on the lesser of:

1) 90% of the tax shown on the return for the tax year (or if no return is filed, 90% of the tax for the year), or
2) 100% of the tax on the return for the preceding year, if that year was a 12-month tax year and a return for that year was filed showing a tax liability.

Large corporation. A ***large corporation*** (one that has at least $1 million of taxable income in any of the last 3 years) may use (1) or (2), if applicable, only for determining the amount of its first installment in any tax year. The difference, if any, between the installment determined under (1) and that determined under (2), must be added to the next required installment.

Order of crediting payments. An estimated tax payment is credited against unpaid installments in the order in which they are required to be paid.

Annualizing. If an installment is based on 90% of the current year's tax that would be due if income were annualized (what the total income for the tax year would have been if an amount of income actually received over a specific period within the tax year were received at the same rate over the full 12-month year), ***no penalty*** is imposed. Any reduction in a required installment from using the annualization exception must be added to the amount of the next required installment if not taken in account in earlier installments.

Recurring seasonal income. When figuring the penalty for an underdeposit of an installment of estimated tax, there is a special rule for a corporation with recurring seasonal income. The rule applies to corporations whose taxable income for any period of 6 consecutive months has averaged 70% or more of its taxable income for the year during each of the past 3 tax years.

No penalty for underdeposit of an installment of estimated tax will apply if the total of all payments of estimated tax paid on or before the installment date equals or exceeds 90% of the amount, figured as follows:

1) Take the taxable income for all months in the tax year that precede the filing month—that is, the month in which the installment is required to be paid.
2) Divide the amount in (1) by the base period percentage, defined below, for all months in the tax year preceding the filing month.
3) Figure the tax on the amount figured in (2).
4) Multiply the tax figured in (3) by the base period percentage for the filing month and all months during the tax year before the filing month.

The ***base period percentage*** for any period of months is the average percentage that the taxable income for the corresponding months in each of the 3 preceding tax years bears to the taxable income for the 3 preceding tax years.

Form 1120-W (WORKSHEET), Corporation Estimated Tax. As an aid in determining the estimated tax and required installments, a corporation should get Form 1120-W (WORKSHEET). The form should be retained and not filed with IRS.

Form 2220, Underpayment of Estimated Tax by Corporations. This form is used to compute the penalty for underpayment of estimated tax. If it appears from your Form 1120 or Form 1120-A that you have underpaid your estimated tax, but you feel that you qualify for relief from the penalty under any of the exceptions, attach a statement to your return explaining why you believe that the penalty should not apply. For this purpose you may use Form 2220.

Quick refund of estimated tax overpayments. A corporation that overpays its estimated income tax may apply on Form 4466, *Corporation Application for Quick Refund of Overpayment of Estimated Tax,* for an adjustment or quick refund of any overpayment. This application must be made after the close of the corporation's tax year and on or before the 15th day of the 3rd month thereafter, and before the day the corporation files a return for that tax year.

The overpayment must be a least 10% of the amount estimated by the corporation on its application as its income tax liability for the tax year and amount to at least $500. The IRS will credit or refund the overpayment within 45 days after the application is filed.

Filing Requirements

Each corporation, unless it is specifically exempt or has dissolved, must file a tax return even if it had no taxable income for the year and regardless of the amount of its gross income for the year. The income tax return for ordinary corporations is Form 1120, *U.S. Corporation Income Tax Return.* Form 1120-A, *U.S. Corporation Short-Form Income Tax Return,* may be filed by certain small corporations. Corporations that normally file Form 1120 will probably save time if they are able to use Form 1120-A.

Form 1120-A can generally be used by a corporation to report its taxable income if it meets the following requirements:

- Its gross receipts must be under $500,000,
- Its total income must be under $500,000,
- Its total assets must be under $500,000,
- It does not have ownership in a foreign corporation,
- It does not have foreign shareholders who own, directly or indirectly, 50% or more of its stock,
- It is not a member of a controlled group or a personal holding company,
- It is not a consolidated corporate return filer,
- It is not a corporation undergoing a dissolution or liquidation,
- It is not filing its final tax return,
- It has no nonrefundable tax credits other than the general business credit and the credit for prior-year minimum tax,
- Its only dividend income is from domestic corporations, and those dividends that qualify for the 80% (or 70%) deduction,
- It is not an organization such as an S corporation, life or mutual insurance company, political organization, etc., that is required to file a specialized form such as Form 1120S, 1120-L, 1120-M, 1120-POL, etc.,
- It has no liability for interest relating to certain installment sales of timeshares and residential lots, or interest on deferred tax liability or installment payments of tax, and
- It is not subject to environmental tax.

For more information, see *Instructions for Forms 1120 and 1120-A.*

Due date of return. If a corporation's income tax return is made on a calendar year basis, it must be filed on or before March 15, following the close of the tax year. If a corporation uses a fiscal year, its return must be filed on or before the 15th day of the 3rd month following the close of its fiscal year. See the checklist on the inside of the back cover of this publication.

Where to file. A corporation files its income tax return with the Internal Revenue Service Center serving the area where the principal office for keeping its books and records is located. Service Center locations are listed in instructions to the forms.

The separate income tax returns of a group of corporations located in several Service Center regions may be filed with the Service Center for the area in which the principal office of the managing corporation (that keeps all the books and records) is located.

Payment of tax. The balance of any income tax due, after installments were paid on estimated tax, must be paid by the due date of the return.

Income tax payment must be made to either an authorized financial institution or a Federal Reserve Bank. All deposits must be made with a federal tax deposit coupon in accordance with the instructions in the coupon book.

Failure to pay tax. Payments made after the due date are subject to an interest charge, even if filing extensions were granted. Payments of income tax other than estimated tax made after the due date may also be subject to a penalty of .5% a month or part of a month up to a maximum of 25%. In certain situations, the amount of the penalty will increase to 1% a month or part of a month up to a maximum of 25%. See Publication 542.

Extension of time for filing. A corporation will receive an automatic 6-month extension of time for filing a return by submitting an application for extension on Form 7004, *Application for Automatic Extension of Time To File Corporation Income Tax Return.* This form is filed with the Internal Revenue Service Center where the corporation will file its income tax return. The IRS may terminate this extension at any time by mailing a notice of termination to the corporation. Form 7004 must be filed by the due date of the corporation's income tax return. Any automatic extension of time for filing a corporation income tax return will not extend the time for paying the tax due on the return.

Automatic extensions of time to file corporate income tax returns will be allowed without payment so long as Form 7004 is accompanied by Form 1138, *Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback,* showing an expected net operating loss carryback that will eliminate the tentative tax shown on Form 7004.

Interest. Interest is charged on the difference in the amount between the tentative tax reported on Form 7004 and the actual tax the corporation must pay when it files its income tax return.

Failure to file. If a corporation's income tax return is not filed by the regular due date (including extensions), and if it cannot show reasonable cause, a delinquency penalty of 5% of the tax due will apply if the delinquency is for one month or less. An additional 5% is imposed for each additional month or part of a month the delinquency continues, not exceeding a total of 25%. The tax due is the tax liability that would be shown on a return less credits and any tax payments made before the due date. The delinquency penalty will be reduced by an amount equal to that imposed under the failure-to-pay tax penalty, which was discussed earlier.

Reasonable cause. A corporation that wishes to avoid a penalty for failure to either file a tax return or pay tax on time must be able to show reasonable cause. This should be done by filing (with the Director of the Service Center where the return must be filed) a statement of the facts establishing reasonable cause for the corporation's failure to file a return or pay the tax on time. In addition, the statement must contain a declaration that it was made under the penalties of perjury.

Amending return. If, after filing Form 1120 or Form 1120–A you have to correct an error on the return, such as understated or overstated income or failure to claim a deduction or credit, you must do so by filing Form 1120X, *Amended U.S. Corporation Income Tax Return.*

Capital Contributions and Retained Earnings

The total contributions made by stockholders to a corporation, whether in exchange for stock or otherwise, are ***paid-in capital.*** These contributions are not taxable income to the corporation.

Contributions by others. If a corporation acquires property as a gift from a city or town as an inducement to locate there, or for any other reason, the property is a contribution to capital with a zero basis.

Reduction of basis. If a corporation receives from a person other than a shareholder a cash contribution for use in acquiring certain property, and the amount contributed is more than the cost of the property acquired, then the basis of the other properties held by the corporation on the last day of the 12–month period beginning on the day the contribution was received must be reduced, but not below zero, in the following order:

1) Depreciable property,
2) Amortizable property,
3) Property subject to cost depletion, but not to percentage depletion, and
4) All other remaining properties.

The basis of property ((1), (2), (3), or (4) above) must be reduced to zero before going to the next category. There may be more than one piece of property in each category.

Accumulation of retained earnings. A corporation is permitted to accumulate its earnings for use in possible expansion or for other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax. If the accumulated earnings tax applies, interest will be charged on the underpayments of the tax from the date the corporate return was originally due, without regard to extensions. This tax applies without regard to the number of shareholders in the corporation.

An accumulation of $250,000 or less is considered within the reasonable needs of a business (except those whose principal function is performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, who have a $150,000 limit). In determining if the corporation has accumulated earnings and profits beyond its reasonable needs, the listed and readily marketable securities owned by the corporation and purchased with its earnings and profits must be valued at net liquidation value, not at cost.

The reasonable needs of a business include:

Specific, definite, and feasible plans for the use of the accumulation in the business, and

The amount necessary to redeem the corporation's stock included in a deceased shareholder's gross estate, provided such amount does not exceed the reasonably anticipated total estate and inheritance taxes, and funeral and administration expenses incurred by the shareholder's estate.

If a corporation with accumulated earnings of more than $250,000 does not make regular distributions to its stockholders, it should be prepared to show a bona fide business reason for not doing so.

For a corporation to avoid liability for accumulated earnings tax, if it accumulates earnings and profits beyond its reasonable business needs, it must show that tax avoidance with respect to its shareholders is not one of the purposes of accumulation. The simple existence of a tax avoidance purpose is sufficient for imposing of the accumulated earnings tax.

Earnings and Profits Computations

In determining the taxable status of corporate distributions to stockholders, it is necessary to know the corporation's earnings and profits.

Taxable distributions are made first from current earnings and profits and then from accumulated earnings and profits. Accumulated earnings and profits means earnings and profits accumulated since February 28, 1913. To the extent the distributions exceed both the current and the accumulated earnings and profits, the distributions may be partly or completely nontaxable.

If the distributions are either partly or completely nontaxable because they exceed current and accumulated earnings and profits, the corporation will need to file Form 5452, *Corporate Report of Nondividend Distributions.* See *Nontaxable dividends,* later, for more information about Form 5452. With Form 5452, you will need to attach computations of current year earnings and profits and accumulated earnings and profits along with schedules reconciling earnings and profits with taxable income and retained earnings. One format for showing the computation of current year earnings and profits may be found in Publication 542.

Distributions

In general, any distribution made out of earnings and profits by a corporation to its stockholders is considered a ***dividend.*** However, a distribution is not a taxable dividend if it is a return of capital to the stockholder. Most distributions are in money, but they may also be made in stock or other property. For information on the proper reporting by stockholders of dividends and other distributions of corporations, see Publication 550, *Investment Income and Expenses.*

A Form 1099–DIV, *Statement for Recipients of Dividends and Distributions,* must be filed with the IRS for each stockholder to whom a corporation pays dividends of $10 or more during a calendar year. The corporation is required to file Form 1096, *Annual Summary and Transmittal of U. S. Information Returns,* to summarize and transmit its Forms 1099–DIV. Form 5452 must be filed if nontaxable dividends are paid. For a discussion of Forms 1096 and 1099, see Chapter 36. Form 5452 is discussed later in this chapter.

Withholding on dividends. Backup withholding may require a corporation to withhold tax equal to 20% of the dividends paid to certain shareholders. See Publication 505, *Tax Withholding and Estimated Tax,* for more information on backup withholding.

Amount of distribution. The amount of a distribution received by a stockholder (corporate or noncorporate) is any money received plus the fair market value of other property received.

The part of a distribution from either current or accumulated earnings and profits is a dividend. The part of the distribution that is more than the earnings and profits must first be used to reduce the adjusted basis of the stock in the hands of the stockholder. Second, any amount that exceeds the adjusted basis of the stock held by the stockholder is to be treated as a gain from the sale or exchange of property (usually a capital gain).

Property. Property means any property including money, securities, and indebtedness to the corporation except stock of the distributing corporation or rights to acquire such stock.

Gain to be recognized by distributing corporation. Generally, the distributing corporation does not recognize gain on a distribution (not in complete liquidation) of property to its stockholders. However, distributions of appreciated property (discussed later) must be considered in determining whether gain is required to be recognized by the distributing corporation.

When a corporation distributes property in satisfaction of its declared dollar dividend amount, it has made a taxable exchange. The declared dollar amount of the dividend is the amount received by the corporation in exchange for its property. But, if the corporation declares a dividend in property, the distribution of property is generally not an exchange in which the corporation realizes income.

(However, see *Gain to be recognized by distributing corporation*, as previously discussed.)

Transfers of property to shareholders for less than fair market value. A sale or exchange of property between a corporation and a shareholder may be a dividend to the shareholder.

If fair market value of the property at the date of distribution exceeds the price paid by the shareholder, the excess is a property distribution. This determination will be made without regard to whether the shareholder is a corporate or noncorporate shareholder.

Corporation canceling debt owed by shareholder. If a corporation cancels a shareholder's debt, without repayment by the shareholder, the amount canceled is treated as a distribution to the shareholder.

Nontaxable dividends. Nontaxable dividends are distributions made to stockholders with respect to their stock in the ordinary course of business, all or part of which are considered not taxable as dividends because the amount of the distributions is greater than the paying corporation's earnings and profits. Form 5452, *Corporate Report of Nondividend Distributions*, must be filed if nontaxable dividends are paid to stockholders. Tax-free stock dividends and distributions in exchange for stock in liquidations or redemptions are not considered nontaxable dividends.

Form 5452. Form 5452 must be filed with supporting data on or before February 28, 1991, with the:

Assistant Chief Counsel
(Income Tax and Accounting)
P O Box 7604
Ben Franklin Station
Washington, DC 20044

Adjustment to earnings and profits. If a distribution is made in cash, the earnings and profits should be decreased by that amount, but not below zero. If the distribution represents an obligation of the distributing corporation, the earnings and profits should be decreased by the principal amount of that obligation to that extent. If it is an original issue discount obligation, earnings and profits are reduced by the total issue price of the obligation. If the distribution is in other property, the earnings and profits should be decreased by the adjusted basis of that property or current earnings and profits, whichever is less.

Constructive dividends—insurance premiums. If a corporation pays part or all of the premiums on insurance issued on the lives of certain stockholders, and both the corporation and the stockholders derive benefits from it, part or all of the premiums paid by the corporation will be a constructive dividend. This is especially true in a closely held corporation. See Chapter 17 for a discussion of insurance.

Distribution of stock and stock rights. A distribution to stockholders of stock or rights to acquire stock in your corporation is not a distribution included in gross income unless it is one of the following:

- A distribution in lieu of money,
- A disproportionate distribution,
- A distribution with respect to preferred stock,
- A distribution of convertible preferred stock, unless your corporation can establish to the satisfaction of the IRS that the distribution will not result in a disproportionate distribution, described later, or
- A distribution of common and preferred stock resulting in the receipt of preferred stock by some common shareholders and receipt of common stock by other common shareholders.

Even if the distribution falls into one of these five categories, there must be sufficient earnings and profits for the distribution to be considered a dividend.

A ***distribution is in lieu of money*** if any shareholders are given an election to be paid either in stock (or rights to acquire stock) or in property.

If the common shareholders of a corporation receive a pro rata distribution of preferred stock and have an option to immediately redeem the preferred stock for money, the distribution is considered to be in lieu of money and a distribution included in gross income.

A ***distribution of stock is disproportionate*** if some shareholders receive cash or other property and other shareholders receive increased proportionate interests in the assets or earnings and profits of the corporation. To determine whether there is a disproportionate distribution with respect to a shareholder, each class of stock is considered separately. Any security convertible into stock or any right to acquire stock is treated as outstanding stock.

Example. Your corporation has two classes of common stock outstanding. If it pays regular cash dividends on the one class and stock dividends on the other (whether in common stock or preferred stock), there is a disproportionate distribution and the stock dividends are considered distributions of property that may be ordinary dividends.

Certain disproportionate distributions of stock or distributions of preferred stock before 1991, on stock outstanding on January 10, 1969, may not be treated as a taxable dividend. For more information, see section 1.305–8 of the Income Tax Regulations.

Expenses of issuing a stock dividend, including printing, postage, cost of advice sheets, fees paid to transfer agents, and fees for listing on stock exchanges are not deductible business expenses. These costs must be capitalized.

30. S Corporations

Important Changes for 1990

Estimated tax payments for S corporations. For tax years beginning in 1990, an S corporation must make quarterly estimated tax payments if its expected liability is $500 or more for the tax on net recognized built-in gain, excess net passive income, and any increase in tax for which the S corporation is liable from the recapture of investment credits.

Health insurance premium. If you are a more than 2% shareholder in an S corporation, you are treated as self-employed for the purpose of contributing to a health insurance plan for yourself, your spouse, and dependents. You may deduct up to 25% of the amount paid on your behalf during the tax year for this health insurance. The deduction has been extended through tax years beginning before January 1, 1992.

For more information on tax law changes, see Publication 553, *Highlights of 1990 Tax Changes*.

A corporation is taxed on its income under corporate tax rules. When it distributes dividends to its shareholders, the shareholders include these already taxed amounts in their income. In effect, corporate income is taxed twice, once to the corporation and again to the shareholders.

However, an eligible domestic corporation can avoid double taxation by electing to be treated as an S corporation under the rules of Subchapter S of the Internal Revenue Code. In this way, the S corporation passes its items of income, loss, deduction, and credits through to its shareholders to be included on their separate returns. Individual shareholders may benefit from a reduction in their taxable income during the first years of the corporation's existence when it may be operating at a loss.

Only qualifying corporations may elect S corporation status.

This chapter discusses how to become an S corporation, and how to terminate an S corporation. For a complete discussion of S corporations, see Publication 589, *Tax Information on S Corporations*.

Becoming an S Corporation

A corporation can become an S corporation if:

1) It meets the requirements of S corporation status.
2) All its shareholders consent to S corporation status.
3) It uses a permitted tax year, or elects to use a tax year other than a permitted tax year, explained later.
4) It files Form 2553, *Election by a Small Business Corporation*, to indicate it chooses S corporation status.

Requirements of an S Corporation

To qualify for S corporation status, a corporation must meet all the following requirements:

1) It must be a domestic corporation. It must be a corporation that is either organized in the United States or organized under federal or state law. The term "corporation" includes a joint-stock company, certain insurance companies, or an association that has the characteristics of a corporation.
2) It must have only one class of stock. See *One class of stock*, later.
3) It must have no more than 35 shareholders. See *Counting shareholders*, later.
4) It must have as shareholders only individuals, estates (including estates of individuals in bankruptcy), and certain trusts. See *Trusts*, later. Partnerships and corporations cannot be shareholders in an S corporation.
5) It must have shareholders who are citizens or residents of the United States. Nonresident aliens cannot be shareholders.

Certain domestic corporations ineligible. Certain domestic corporations are ineligible to elect S corporation status, such as:

1) A member of an affiliated group of corporations. Generally, an affiliated group means one or more chains of corporations connected through stock ownership with a common parent corporation that is also part of the group. The common parent must directly own stock that possesses at least 80% of the total voting power of the stock of at least one of the corporations, and the stock must have a value equal to at least 80% of the total value of the stock of that corporation. Stock does not include certain preferred stock. A corporation is a member of an affiliated group if it directly owns 80% or more of the total combined voting power of stock entitled to vote and 80% or more of the total value of all other stock, except for preferred stock, of another corporation. However, see *Subsidiaries*, later, for exceptions to this rule.
2) A DISC (Domestic International Sales Corporation) or former DISC.
3) A corporation that takes the Puerto Rico and possessions tax credit for doing business in a United States possession.
4) A financial institution that is a bank, including mutual savings banks, cooperative banks, and domestic building and loan associations.
5) An insurance company taxed under Subchapter L of the Internal Revenue Code.

One class of stock. One class of stock generally means that the outstanding shares of the corporation must be identical as to the rights of the holders in the profits and assets of the corporation. Stock may have differences in voting rights and still be considered one class of stock if all other rights are identical.

A stock purchase agreement executed between an S corporation and its shareholders that does not affect the shareholders' rights in the corporation's profits and assets will not create a second class of stock.

Debt obligations of a corporation that are actually contributions of equity capital may be treated as a second class of stock. However, straight debt will not be considered a second class of stock.

The term "straight debt" means any written unconditional promise to pay a fixed amount on demand or on a specific date, if:

1) The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors,
2) The debt cannot be converted directly or indirectly into stock, and
3) The creditor is an individual, estate, or trust eligible to hold stock in an S corporation.

Unissued stock. Authorized but unissued stock and treasury stock are not considered in determining if a corporation has more than one class of stock. Nor is special stock issued to the Federal Housing Administration considered when making this determination. The existence of outstanding options, warrants to acquire stock, or convertible debentures will not, by itself, be considered a second class of stock.

Counting shareholders. An S corporation cannot have more than 35 shareholders. When counting shareholders, the following rules apply:

1) Count the persons who are considered to be shareholders if the stock is actually held by a trust. See *Trusts*, later. Do not count the trust itself as a shareholder.
2) Count a husband and wife, and their estates, as one shareholder, even if they own stock separately.
3) Otherwise, count everyone who owns any stock, even if the stock is owned jointly with someone else.

Trusts. The following trusts, other than foreign trusts, can be shareholders of an S corporation:

1) A trust all of which is treated as owned by an individual who is a United States citizen or resident. The individual, not the trust is treated as the shareholder.
2) A trust that qualified under (1) before the owner's death, and continues in existence after the owner's death, may continue to be an S corporation shareholder for stock held by the trust when the owner died, but only for a period no longer than 60 days, beginning on the date of the owner's death. However, if the corpus of the trust is included in the owner's gross estate, the 60–day period becomes a 2–year period. The owner's estate is treated as the shareholder.
3) A trust created primarily to exercise the voting power of stock transferred to it. Each beneficiary of the trust is treated as a shareholder.
4) Any trust to which stock is transferred according to the terms of a will, but only for 60 days, beginning with the day the stock was transferred to the trust under the will. The estate of the person leaving the will is treated as the shareholder.

Qualified subchapter S trusts. In addition, the beneficiaries of certain other trusts can elect to have their trusts qualify as a trust described in (1), above. These trusts are known as "qualified subchapter S trusts." A qualified subchapter S trust is a trust described in section 1361(d) of the Code.

Subsidiaries. Generally, an S corporation cannot have a subsidiary that would cause it to be a member of an affiliated group of corporations. However, there are two exceptions to this rule:

1) Inactive subsidiary, and
2) Former DISC or foreign corporation as a subsidiary.

Inactive subsidiary. An inactive subsidiary is one that, during any period within a tax year:

1) Has not begun business at any time on or before the close of that period, and
2) Does not have gross income for that period.

Former DISC or foreign corporation as a subsidiary. A corporation that holds a foreign corporation or former DISC as a subsidiary is not eligible to be an S corporation, unless it qualified under the "grandfather rules" of the Subchapter S Revision Act of 1982.

Shareholder Consents

The corporation's election of S corporation status is valid only if all shareholders consent to the election. A shareholder's consent is binding and may be withdrawn only as explained later under *Revoking S Corporation Status*.

Form of consent. Shareholders may consent by providing the required information on Form 2553, *Election by a Small Business Corporation*, and signing in the appropriate space.

All shareholders must consent at the time Form 2553 is filed. If the consent is filed after the beginning of the year for which it is to be effective, all shareholders in the corporation who held stock on any day in the tax year before the date Form 2553 is filed must also consent.

An election made during the first 2 1/2 months of the tax year is considered made for the following tax year if one or more of the persons who held stock in the corporation during the tax year and before the election was made did not consent to the election.

The shareholder may also consent by signing a separate consent statement, which should be attached to Form 2553. The separate consent should provide the following information:

1) The name, address, and taxpayer identification number of the corporation.
2) The name, address, and taxpayer identification number of the shareholder.
3) The number of shares of stock owned by the shareholder and the date or dates acquired.
4) The day and month of the end of each shareholder's tax year.

The consents of all shareholders may be included in one statement. The corporation's election of S corporation status is invalid if any consent is not filed on time. However, if the corporation's election would be valid except for the failure of a shareholder to file a consent on time, that shareholder may apply for an extension of time to file the consent. The request for an extension of time to file should be sent to the Internal Revenue Service Center where Form 2553 was filed.

The time for filing a consent may be extended, if:

1) It is shown to IRS's satisfaction that there was reasonable cause for the failure to file the consent and that the government's interest will not be jeopardized by treating the election of S corporation status as valid,
2) The shareholder who did not file a proper consent files the proper consent within the extended time granted by the IRS, and
3) All shareholders file new consents within the extended time. ***All*** shareholders include anyone who was a shareholder during the period for which the extension is granted.

Who must consent. Generally, each person who is a shareholder at the time the election is made must consent. If the election is made during the corporation's first tax year in which S corporation status is effective, each person who was a shareholder at any time during the part of the tax year before the election is made must also consent to S corporation status for the corporation.

Co-owners. Each co-owner, tenant by the entirety, tenant in common, and joint tenant must consent. If stock is owned as community property, or if income from the stock is community property, both husband and wife must consent.

Minors. The consent of a minor must be made by the minor or his or her legal representative (or a natural or adoptive parent of the minor if no legal representative has been appointed).

Estates. The consent of an estate holding stock in an S corporation must be made by the executor or administrator of the estate.

Trusts. The consent of a qualified trust holding stock in a newly elected S corporation must be made by each person who is treated as a shareholder for purposes of determining whether the corporation meets S corporation requirements. See *Trusts*, earlier, under *Requirements of an S Corporation.*

Tax Year

A permitted tax year is a calendar year or any other accounting period for which the corporation establishes a business purpose to IRS's satisfaction. In addition, an S corporation may elect under section 444 to have a tax year other than the permitted tax year.

For more information on business purpose, see Publication 589.

A corporation electing S corporation status does not need IRS's approval to choose a calendar year as its tax year. An electing S corporation should use Form 2553, *Election by a Small Business Corporation,* discussed later, to request a tax year other than a calendar year or to make the section 444 election.

Change of tax year. An S corporation should file Form 1128, *Application to Adopt, Change, or Retain a Tax Year,* to apply for permission to change its tax year to a year other than a year ending December 31. This form should be filed by the 15th day of the second calendar month after the close of the short tax year. This short tax year begins on the first day after the end of the corporation's present tax year and ends on the day before the opening date of its new tax year.

The corporation must submit a ***user fee*** of $200 with Form 1128. Form 1128 and the user fee should be filed with:

The Commissioner of Internal Revenue
Attention: CC:CORP:T
P.O. Box 7604
Benjamin Franklin Station
Washington, DC 20044

The package should be marked "Ruling Request Submission."

The application should contain all the requested information. It should show that there is a business purpose for the change. The deferral of income to shareholders generally will not be treated as a business purpose.

Note. Form 1128 should not be used to request a tax year for or during the first year the corporation elects to be an S corporation.

Section 444 election. S corporations may elect the use of a tax year different from the permitted tax year. Certain restrictions apply to this election.

For more information on the section 444 election, see Chapter 3.

Making the election. Unless you are a corporation electing S corporation status, make the section 444 election by filing Form 8716, *Election To Have a Tax Year Other Than a Required Tax Year,* with the Internal Revenue Service Center where you normally file your returns. Form 8716 must be filed by the earlier of:

1) The 15th day of the 5th month following the month that includes the first day of the tax year for which the election will first be effective, or
2) The due date, without extensions, of the income tax return resulting from the section 444 election.

In addition, you must attach a copy of Form 8716 to your Form 1120S, *U.S. Income Tax Return for an S Corporation,* for the first tax year for which the election is made.

Required payment for S corporations. S corporations must make a required payment for any tax year that the section 444 election is in effect and the required payment amount is more than $500 for the tax year or any previous tax year. Form 8752, *Required Payment or Refund Under Section 7519,* is used to figure the required payment or refund. For election years beginning in 1990, Form 8752 must be filed and any required payment made by May 15, 1991.

For more information on the required payment, see the instructions for Form 8752.

Form 2553 – Electing S Corporation Status

To be treated as an S corporation, a corporation must file Form 2553 to indicate its election of S corporation status. The corporation must qualify as an S corporation when it files its Form 2553. Form 2553 should also be used to file shareholder consents and to select a tax year.

Form 2553 should be filed with the Internal Revenue Service Center where the S corporation will file its income tax return.

When to file Form 2553. The election of S corporation status is effective for a tax year if Form 2553 is filed:

1) Any time during the previous tax year, or
2) By the 15th day of the 3rd month of the tax year to which the election is to apply.

For detailed information on filing Form 2553, see the instructions to Form 2553.

Terminating S Corporation Status

The corporation's status as an S corporation may be terminated in any of the following ways:

- By revoking the election
- By ceasing to qualify as an S corporation
- By violating the passive investment income restrictions on S corporations with pre-S corporation earnings and profits.

Terminations are generally effective on the date of the terminating event. For a termination effective on a day that is not the first day of a tax year, see the discussion under *S Termination Year,* later.

Inadvertent termination. If a corporation's status is terminated because it inadvertently ceased to qualify as an S corporation or it inadvertently violated the restriction on passive investment income, the IRS may waive the termination. The termination may be waived if the IRS determines that the termination was inadvertent, the corporation takes steps to correct the event within a reasonable period of time, and the corporation and its shareholders agree to be treated as if the event had not happened.

For more information on inadvertent terminations, see Publication 589, *Tax Information on S Corporations.*

Five-year waiting period. If a corporation's status as an S corporation has been terminated, it generally must wait 5 tax years before it can again become an S corporation. If it gets the permission of the IRS, the waiting period may be less than 5 years.

Revoking S Corporation Status

An S corporation election may be revoked by the corporation for any tax year. The S corporation status can be revoked only if shareholders who collectively own more than 50% of the outstanding shares in the S corporation's stock consent to the revocation. The consenting shareholders must own their stock in the S corporation at the time the revocation is made.

How to revoke. The revocation must be made by the corporation in the form of a statement. The statement must provide:

1) That the corporation is revoking its election to be treated as an S corporation under section 1362(a) of the Internal Revenue Code,
2) The number of shares of stock (including nonvoting stock) outstanding at the time the revocation is made, and
3) The date on which the revocation is to be effective for revocations that specify a prospective revocation date.

This statement should be signed by someone authorized to sign the S corporation's return. It should be sent to the service center where the corporation filed its election to be an S corporation.

To this statement of revocation, the corporation should attach a statement of consent signed by each shareholder who consents to the revocation. It should also provide the number of shares of outstanding stock (including nonvoting stock) each consenting shareholder holds at the time the revocation is made.

Effective date of revocation. The revocation is effective:

1) On the 1st day of the tax year if the revocation is made by the 15th day of the 3rd month of the same tax year.
2) On the 1st day of the following tax year if the revocation is made after the 15th day of the 3rd month of a tax year.
3) On the date specified if the revocation specifies a date on or after the day the revocation is made.

A corporation that specifies a prospective date for revocation that is other than the first day of the tax year will create an S termination year.

See *S Termination Year,* later, for information on filing returns for the S termination year.

Ceasing To Qualify

A corporation's status as an S corporation will be terminated if at any time the corporation ceases to qualify as an S corporation. If the corporation inadvertently ceases to qualify, see the earlier discussion of *Inadvertent termination.*

Certain events can cause the corporation to cease qualifying as an S corporation. Some of these include:

- Having more than 35 shareholders
- Transferring stock in the S corporation to
  - —A corporation,
  - —A partnership,
  - —An ineligible trust, or
  - —A nonresident alien
- Creating a second class of stock
- Acquiring a subsidiary, other than certain nonoperating subsidiaries.

Effective date of termination. A termination of S corporation status will be effective as of the date the terminating event occurred.

A corporation that ceases to be an S corporation on a date other than the first day of the tax year will create an S termination year.

For more information on filing tax returns for the S termination year, see *S Termination Year,* later.

Violating the Passive Income Restriction

A corporation's status as an S corporation will be terminated if both of the following conditions occur for 3 consecutive tax years:

1) It has pre-S corporation earnings and profits at the end of each tax year.

2) Its passive investment income for each tax year is more than 25% of gross receipts.

See Publication 589 for a discussion of passive investment income.

Effective date of termination. A termination of S corporation status because of a violation of the passive income restriction will be effective on and after the first day of the first tax year that begins after the third consecutive tax year referred to above. See also *Inadvertent termination,* discussed earlier.

S Termination Year

Any termination described previously in *Revoking S Corporation Status* and *Ceasing To Qualify* that is effective during the tax year on a date other than the first day of that tax year will create an S termination year. The part of the S termination year ending on the date before the effective date of the termination will be treated as an 1120S (S corporation) short tax year. The part of the S termination year beginning on the first day on which the termination is effective is an 1120 (C corporation) short tax year.

After the S termination year is divided into an 1120S short year and an 1120 short year, the separately stated items of income, credit, and deduction, and the amount of the nonseparately stated income or loss must be divided between the periods. There are two methods that can be used to make this division. They are:

1) A pro rata allocation, or

2) An allocation based on normal tax accounting rules.

After the separately stated items and the nonseparately stated income or loss are divided, one set of amounts is used for the 1120S short year and the other set of amounts is used for the 1120 short year.

The corporation will have to file two returns to cover the S termination year. One covers the 1120S short year and one covers the 1120 short year. The S termination year will count only as one year for figuring carrybacks and carryforwards, even though two returns are filed for the year.

For more information, see Publication 589.

Part VII
Credits, Other Taxes, and Information Returns

This Part discusses certain tax credits you may be able to claim, certain federal taxes you may have to pay, and information returns you may have to file in the course of your trade or business.

31. General Business Credit

Important Changes for 1990

General business credit. The following credits, which are part of the general business credit are extended through December 31, 1991—The jobs credit, research credit, energy investment credit, and low-income housing credit.

Disabled access credit. An eligible small business is allowed a nonrefundable tax credit for expenses paid or incurred after November 5, 1990. This credit is equal to 50% of the amount of eligible access expenses for the tax year that are more than $250 but not more than $10,250. Generally, an eligible small business is one which in the preceding tax year had either gross receipts of not more than $1,000,000 or no more than 30 full-time employees. See Publication 553, *Highlights of 1990 Tax Changes*, for more information.

The general business credit consists of the following credits: investment credit, jobs credit, alcohol fuel credit, research credit, low-income housing credit, or a carryover of any eligible credit from another tax year.

If you need more information about the credits than you find in this chapter, see Form 3800, *General Business Credit.*

Tax limit. There is a limit on how much general business credit you can take in any one tax year. If your credit is more than this limit, you generally can carry the excess to another tax year and subtract it from your income tax for that year. See *Rule for carrybacks and carryovers*, later.

Your general business credit is limited to your net income tax *minus*

1) Your tentative minimum tax, or
2) 25% of your income tax liability that is more than $25,000,

whichever is *larger.*

Net income tax. Your net income tax is your income tax liability plus your alternative minimum tax. Your ***income tax liability*** is your regular tax liability minus certain credits.

Use Form 3800 to figure your general business credit. You must use Form 3800 if you have more than one of the credits listed earlier, if you have a carryover credit from another tax year, or if you have a credit from a passive activity. For information about passive activity credits, see Form 8582-CR, *Passive Activity Credit Limitations.*

You must determine your tentative minimum tax before you figure your general business credit. Figure your tentative minimum tax on Form 6251, *Alternative Minimum Tax—Individuals.*

Example. Your general business credit for the year is $30,000. Your net income tax is $27,500. Your tentative minimum tax, figured on Form 6251, is $18,487. The amount of general business credit you can take for the tax year is limited to $9,013. This is your net income tax, $27,500, minus the ***larger of*** your tentative minimum tax, $18,487, or 25% of your income tax liability that is more than $25,000 (25% of $2,500 = $625).

Married persons filing separate returns. If you are married and file a separate return, you must each figure your limit separately. In figuring your separate limit, use $12,500 instead of $25,000. However, if one spouse has no credit for the tax year and no carryovers or carrybacks of any credit to that year, the other spouse can use the full $25,000 instead of $12,500 in figuring the limit based on the separate tax.

Rule for carrybacks and carryovers. In general, you can carry the unused portion of your credit back to your last 3 tax years and use it to reduce your tax in those years. First, carry the unused portion to the earliest of your last 3 years. If you cannot use it all in that year, carry the remaining unused portion to the second earliest year and so on. Any unused credit that you could not take in these 3 earlier years can be carried forward in the same way to the next 15 tax years until it is used up.

Credits must be used in the order in which they are earned.

1) First, for any tax year, use your credit carryover (earliest year first).
2) Next, use the current year's credit.
3) Finally, use your credit carrybacks (earliest year first).

Unused carryover. If you have any unused credit carryover in the year following the end of the 15-year carryover period, you generally can deduct the unused amount. This deduction is limited to 50% of any unused investment credit.

If an individual dies or a corporation, trust, or estate ceases to exist, the deduction is allowed for the tax year in which the death or cessation occurs.

Refunds. A claim for refund based on your general business credit carryback to a prior tax year can be made by filing an amended return for the tax year to which you carry the unused credit. Use Form 1040X if your original return was a Form 1040. Use Form 1120X if your original return was a Form 1120 or 1120–A. Attach Form 3800 to your amended return.

Generally, you must file the amended return for the carryback year no later than 3 years after the due date, including extensions, for filing the return for the year that resulted in the credit carryback.

Quick refunds. You can apply for a quick refund of taxes for a prior year by filing Form 1045 (Form 1139 for a corporation) to claim a tentative adjustment of tax from a general business credit carryback. The application should be filed on or after the date of filing the tax return for the carryback year, but must be filed no later than 12 months after the end of the tax year in which you earn the credit.

Investment Credit

The ***regular investment credit*** has been repealed for property placed in service after December 31, 1985. However, there are two exceptions that may apply to you. The exceptions are for qualified timber property and for transition property.

Qualified timber property. The regular investment credit is available for up to $10,000 of the expenses you incur each year to forest or reforest property you hold for growing trees for sale or for use in the commercial production of timber products. These expenses must qualify for amortization. You can take the investment credit for reforestation expenses whether you choose to amortize them or add them to the basis of your property. For more information about these expenses, see *Timber* in Chapter 13.

Transition property. Transition property is property you place in service after December 31, 1985, if on that date you had a binding, written contract for its acquisition, construction, or reconstruction. See the instructions for Form 3468 for more information.

Rehabilitation credit. The rehabilitation credit is an investment credit for expenses you incur for rehabilitation and reconstruction of certain buildings. The percentages of your expenses that you can take as a credit are 10% for buildings that were placed in service before 1936 and 20% for certified historic structures. See Form 3468, *Investment Credit*, for more information.

Business energy credit. The energy credit is available through December 31, 1991, for solar, geothermal, and through September 30, 1990, for ocean thermal property.

The credit percentage for solar property is 10%; for geothermal property, 10%; and for ocean thermal property, 15%.

Basis adjustment. You must generally reduce the depreciable basis of assets on which you take an investment credit. The reduction is 100% of any regular investment credit, and 50% for qualified timber property. See Form 3468 for more information.

Carrybacks and carryovers. Even if you cannot take an investment credit for 1990, you may have credits from earlier years that you were unable to use, and you may be able to use them to reduce your 1990 tax. These unused credits from earlier years are carried to your current tax year as general business credit carryovers, and the rules for the general business credit, discussed earlier, apply.

Recapture of Investment Credit

At the end of each tax year, you must determine whether you disposed of or stopped using in your business (either partially or entirely) any property for which you claimed investment credit in a prior year. If you dispose of property before the end of the recapture period, you must recapture a percentage of the credit by adding it to your tax. See *Recapture Rule*, later, for a discussion of recapture period.

Use Form 4255, *Recapture of Investment Credit*, to figure the recapture tax. Or you may attach a detailed statement to your return for the year you dispose of the asset showing the computation of the recapture and the decrease in any investment credit carryover.

Dispositions

An outright sale of property is the clearest example of a disposition. Another type of disposition occurs when you exchange or trade in worn-out or obsolete business assets for new ones. You also have a disposition of property for investment credit recapture purposes if the property ceases to be qualifying property. An example is when business property is converted to personal use.

Not every transaction results in a disposition for investment credit recapture purposes. The following are some examples of transactions that may or may not be dispositions.

Mortgaging and foreclosure. There is no disposition if title to property is transferred as security for a loan. However, a disposition does occur if there is a transfer of property by foreclosure.

Leased property. The leasing of investment credit property by the lessor who took the credit is generally not a disposition. However, if the lease is treated as a sale for income tax purposes, it is a disposition. A disposition also occurs if the property ceases to be investment credit property in the hands of the lessor, the lessee, or any sublessee.

Decrease in basis. If the basis of investment credit property decreases, the amount of the decrease is considered to be a disposition. This occurs, for example, if you buy property and later receive a refund of part of the original purchase price. You must then refigure the credit as if the amount of the decrease in basis was never part of the original basis. If your refigured credit is less than the credit you originally took, you must add the difference to your tax.

Retirement or abandonment. You dispose of property if you abandon it or otherwise retire it from use. Normal retirements are also dispositions.

Transfer by reason of death. There is no disposition of investment credit property if the property is transferred because the owner-taxpayer died.

Gifts. Property transferred by gift is considered disposed of.

Transfers between spouses. If you transfer investment credit property to your spouse, or you transfer the property to your former spouse incident to a divorce, you generally are not considered to have disposed of the property. This also applies if the transfer is made in trust for the benefit of the spouse or former spouse. However, if the spouse or former spouse transfers the property, the transfer will receive the same tax treatment that would apply to you if you had made the transfer.

Casualty or theft loss. Property destroyed by casualty or lost by theft is treated as having been disposed of.

Choosing S corporation status. The choice by a corporation to become an S corporation generally will not cause the recapture of investment credit previously claimed by the corporation. The choice is treated as a change in the form of doing business and not as a disposition of property. No disposition occurs when an S corporation terminates or revokes its choice not to be taxed as a corporation.

Disposition of assets by S corporation, partnership, estate, or trust. If you are a shareholder of an S corporation that disposes of assets on which you figured investment credit, you are treated as having disposed of the share of the investment on which you figured your credit. This same rule applies if you are a member of a partnership or a beneficiary of an estate or trust.

Change in form of doing business. A disposition does not occur because of a change in the form of doing business provided that certain conditions are met. For more information, see section 1.47-3(f) of the Regulations.

Sale and leaseback. There is no disposition when investment credit property is sold by the taxpayer who claimed the credit and then is leased back to that taxpayer as part of the same transaction.

At-risk reduction. If the amount of your investment for which you are at risk is reduced, you are subject to the recapture rules. See the instructions for Form 3468 for more information.

Recapture Rule

If you dispose of property for which you claimed the investment credit before the end of the recapture period (defined in the next paragraph), you must recapture, as an additional tax, part of the credit you claimed originally. You may also have to recapture if you change the use of investment tax credit property to a use that would not have originally qualified for the credit.

The amount of credit that you must recapture depends upon when during the recapture period you dispose of, or change the use of, the property. The ***recapture period*** is the length of time the property must be used in order to get the full investment credit.

Use Form 4255 to figure the recapture amount. The credit recapture is figured by multiplying a recapture percentage, from the tables in Form 4255, by the original investment credit taken. The result of this computation is the amount of the recapture. See Form 4255 for more information.

If the refigured credit is less than the credit that you actually took in the year the asset was placed in service, and also for any carryback and carryover years, you must add to your tax, for the year the asset is disposed of, the difference between the original credit taken and the refigured credit.

Net operating loss carrybacks. If you have a net operating loss carryback from the recapture year or a later year that reduces your tax for the recapture year or an earlier year, you may have to refigure your recapture. See section 1.47-1(b)(3) of the Regulations.

Low-Income Housing Credit

This credit generally applies to qualified low-income housing buildings placed in service after 1986. Use Form 8586, *Low-Income Housing Credit*, to claim the credit. For more information, see Form 8586 and section 42 of the Internal Revenue Code.

Jobs Credit

The jobs credit is available through December 31, 1991, for qualified wages paid to employees.

This credit provides an incentive to hire persons from targeted groups that have a particularly high unemployment rate or other special employment needs. The credit is for qualified wages you incur or pay to certified members of targeted groups. In general, you must receive or request in writing, by the employee's first workday, the certification from your state employment security agency (jobs service).

Wages to use for determining the credit. Only qualified first-year wages can be used to figure the credit. In addition, you cannot take a credit on wages paid to an otherwise eligible employee who works for you less than 90 days or 120 hours (14 days or 20 hours for a qualified summer youth employee).

Wages you pay to an employee in any tax year will qualify for the credit only if more than one-half of the wages are for work done in your trade or business.

For you to take this credit, the employee must be certified as a member of a targeted group. An individual is a member of a targeted group if that individual is one of the following:

1) A vocational rehabilitation referral,
2) An economically disadvantaged youth,
3) An economically disadvantaged Vietnam-era veteran,
4) A Supplemental Security Income (SSI) recipient,
5) A general assistance recipient,
6) A youth participating in a cooperative education program,
7) An economically disadvantaged ex-convict,
8) An eligible work incentive employee, or
9) A qualified summer youth employee.

Certification must be made by the designated local agency or, in the case of a cooperative education student, by the participating school. Designated agencies are local offices of a state employment security agency (jobs service).

You cannot claim a credit for wages you pay to a related individual.

File Form 5884, *Jobs Credit*, with your tax return to claim the credit. If the jobs credit is from a passive activity, or if you have an investment credit, an alcohol fuel credit, a research credit, or a low-income housing credit for the tax year, or a carryover of any credit from another tax year, you will also have to file Form 3800.

Any unused credit can be carried back 3 tax years or forward 15 tax years as part of the general business credit. For more information on the jobs credit, see Form 5884.

Research Credit

The research credit is designed to encourage businesses to increase the amounts they spend on research and experimental activities.

For expenses paid or incurred through December 31, 1991, the research credit is 20% of the amount by which your research expenses for the year are more than the average of your base period amount. See Form 6765, *Credit for Increasing Research Activities,* for definitions and information on how to figure the credit.

File Form 6765 with your tax return to claim the credit. If the research credit is from a passive activity, or if you have an investment credit, an alcohol fuel credit, a jobs credit, or a low-income housing credit for the tax year, or a carryover of any credit from another year, you will also have to file Form 3800.

Any unused credit can be carried back 3 years or forward 15 years as part of the general business credit. For more information on the research credit, see Form 6765.

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32. Self-Employment Tax

Important Changes for 1990

New wage maximums and tax rates for self-employment taxes. In 1990, the tax rate for self-employment taxes is 15.3% on net earnings up to a maximum of $51,300, and the 2% credit for 1989 has been replaced by two deductions. The 15.3% tax rate is a total of 12.40% for social security (old-age, survivors, and disability insurance), and 2.90% for Medicare (hospital insurance). See *Tax rates* under *Figuring Self-Employment Tax.*

In 1991, the tax rate will remain at 15.3% but the maximum net earnings subject to the social security portion (12.40%) increase to $53,400, while the maximum net earnings subject to the Medicare portion (2.90%) increase to $125,000.

The self-employment tax is a social security tax for individuals who work for themselves. It is similar to the social security tax withheld from the pay of wage earners. You may be liable for self-employment tax even if you are now fully insured under social security and are now receiving benefits.

Social Security benefits. Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of self-employment tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits and medical insurance (Medicare) benefits.

Social security coverage. In 1990, you will receive a quarter of social security coverage, up to four quarters, for each $520 ($540 in 1991) of self-employment income subject to the self-employment tax.

Social security number. You must have a social security number to pay self-employment tax. If you do not have a number, you should apply for one at the nearest Social Security office. You may get an application, Form SS-5, *Application for a Social Security Card,* from any Social Security office.

Who Must Pay the Tax

If you carry on a trade or business, except as an employee, you probably have to pay self-employment tax on your self-employment income. A trade or business is generally an activity carried on for a livelihood, or in good faith to make a profit. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business. Regularity of activities and transactions and the production of income are important elements.

The facts and circumstances of each case determine whether or not an activity is a trade or business.

Statutory employees. If you earned wages as a statutory employee, the box titled "Statutory employee" on line 6 of Form W-2, *Wage and Tax Statement,* will be checked. A statutory employee should file a separate Schedule C, *Profit or Loss From Business,* to report only the income and expenses related to his or her earnings as a statutory employee. However, a statutory employee does not have to pay the self-employment tax on those earnings because social security (FICA) taxes have been withheld from the earnings.

If you have other earnings from self-employment together with wages as a statutory employee, do not include the earnings as a statutory employee in net profit on lines 1 or 2 of Schedule SE, *Social Security Self-Employment Tax.* Include your earnings as a statutory employee in social security wages on line 6 of Schedule SE, and show your other earnings from self-employment on lines 1 and 2 of Schedule SE, and on a separate Schedule C.

Income limits. You must pay self-employment tax if you have net earnings from self-employment of $400 or more. You must also pay self-employment tax if you are paid $100 or more in a year as an employee of a church or qualified church-controlled organization that elected exemption from social security taxes. However, see *Religious Exemptions* in Publication 533, *Self-Employment Tax.*

The minimum amounts, above, apply after your net earnings or income are first reduced by the new 7.65% deduction for figuring self-employment tax, discussed later.

The maximum amount of 1990 earnings subject to self-employment tax is $51,300. However, no self-employment tax is due on your self-employment income if the wages you received in 1990 as an employee were $51,300 or more, and were subject to social security tax, railroad retirement tax, or both.

Note: If you were a U.S. Government employee subject only to the 1.45% Medicare (hospital insurance benefits) tax, and your combined wages and self-employment earnings were in excess of $51,300, compute your self-employment tax by using the worksheet in the Form 1040 instructions for Schedule SE.

The Medicare tax (including use of the worksheet mentioned above) applies to most state and local government employees hired after March 31, 1986, and to state and local government employees hired on or before that date who are covered by voluntary agreements with the Secretary of Health and Human Services.

Estimated income tax. You may be required to pay estimated tax on your self-employment income. This depends on how much income and self-employment tax you expect for the year and how much of your income will be subject to withholding tax.

If you have a regular job, you may cover your estimated self-employment income and estimated self-employment tax payments by having your employer increase the amount of income tax withheld from your pay.

Self-Employment Income

You are probably self-employed if you are a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself.

You do not have to carry on regular full-time business activities to be self-employed. Part-time work, in addition to your regular job, may also be self-employment.

Some types of income, such as interest, may or may not be self-employment income. The source of your income and your involvement in the activity from which your income is received will determine whether it is self-employment income. Different kinds of self-employment income and other types of income are discussed here.

Aliens. Nonresident aliens do not have to pay self-employment tax. Residents of the Virgin Islands, Puerto Rico, Guam, or American Samoa, however, are subject to the tax. For self-employment tax, they are not considered nonresident aliens. For more information on U.S. possession self-employment income, see Publication 533.

Capital gains and losses. Capital gains and losses, such as gain or loss on the sale of investment property, are excluded from self-employment income.

Other gains and losses. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included when figuring self-employment income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included:

1) Depreciable property or other fixed assets used in your trade or business.
2) Livestock held for draft, dairy, breeding, or sporting purposes and not held primarily for sale, regardless of how long the livestock were held or whether they were raised or purchased.
3) Standing crops sold with land held more than one year.
4) Timber, coal, or iron ore held for more than one year, if an economic interest was retained, such as a right to receive coal royalties.
5) The cutting of timber, if treated as a sale or exchange.

However, amounts recaptured under sections 179(d)(10) and 280F(b)(3) of the Internal Revenue Code, because the business use of the property was reduced to 50% or less, are taken into account in figuring your net earnings from self-employment. (This does not include amounts recaptured on the disposition of property.)

Corporate payments. Whether income received from a corporation is self-employment income will depend on the particular source of that income.

Corporate director. Fees received for performing services as a director of a corporation are self-employment income. It does not matter whether the fees are for going to director's meetings or for serving on committees. A corporate director's earnings are treated as received when the services are performed for self-employment purposes, regardless of when paid. However, these earnings are not subject to income tax until they are actually received.

Corporate employee. Even if you own most or all of the stock of a corporation, your income as an employee or officer of the corporation is not self-employment income.

Member of an unincorporated organization. Income you receive as a member of an unincorporated organization that has certain corporate characteristics and that is classified as an association taxable as a corporation is generally not self-employment income. See Publication 542, *Tax Information on Corporations.*

S corporations. If you are a shareholder in an S corporation, your share of the corporation's taxable income is not self-employment income, even though you include it in your gross income for income tax purposes.

Dividends. Dividends on securities are not self-employment income unless you are a dealer in securities.

Independent contractor. An individual doing bookkeeping and related services for several clients as an independent contractor is engaged in a trade or business. Income from this work is self-employment income.

Newspaper carriers. The income newspaper carriers receive for delivering newspapers or shopping news to customers is not self-employment income. However, if they are age 18 or over, their income is subject to social security tax (FICA).

Newspaper vendors. The income newspaper vendors receive for selling newspapers or magazines directly to customers for a profit is not self-employment income if the vendor is under age 18. However, if the vendor is 18 or over, the income is self-employment income.

Interest. Interest is not self-employment income unless you receive it in your trade or business. This includes interest on accounts receivable or from bonds, notes, etc., if you are a dealer in stocks or securities.

Religious exemptions. Members of the clergy and Christian Science practitioners are subject to self-employment tax unless they get an exemption. Members of certain religious sects, however, may be exempt from self-employment tax. See Publication 517, *Social Security for Members of the Clergy and Religious Workers.*

Partnerships. If you are a member of a partnership that carries on a trade or business, you must include your distributive share of partnership income or loss in figuring your net earnings from self-employment. Guaranteed payments from your partnership should be included, along with your share of earnings or minus your share of losses when you figure your net earnings from self-employment. See Chapter 28.

Inactive partner. An inactive partner figures income from self-employment by including the distributive share of partnership income or loss and any guaranteed payments.

Limited partner. A limited partner figures self-employment income by excluding the distributive share of partnership income or loss. But guaranteed payments, such as salary and professional fees, received for services performed during the year are included as self-employment income.

Retired partner. A retired partner pays no self-employment tax on retirement income received from the partnership under a written plan if:

1) The retired partner receives life-long periodic payments,
2) The retired partner's share of the partnership capital was fully repaid to the retired partner,
3) The retired partner performs no services for the partnership during the year, and
4) The partnership owes the retired partner nothing but the retirement payments.

Different tax years. If your tax year is not the same as your partnership's, report your distributive share of partnership income or loss on your return for the year that includes the end of the partnership tax year.

Example. You file your return on a calendar year basis, but your partnership uses the fiscal year ending January 31. You must include on your return for calendar year 1990 your distributive share of partnership earnings and your guaranteed payments for the fiscal year ending January 31, 1990.

For additional information on figuring your income from a partnership, see Chapter 28.

Professional. The income that a doctor, as a sole practitioner, receives from the practice of medicine is earnings from a trade or business. It is self-employment income.

Public officials. Public officials generally do not pay self-employment tax on what they earn in their official positions. Public office includes any elective or appointive office of the United States or its possessions, the District of Columbia, a state or its political subdivisions, or a wholly owned instrumentality of any of these.

However, public officials of state or local governments must pay self-employment tax on their fees if they are paid solely on a fee basis and if their services are eligible for, but not covered by, social security under a federal-state agreement.

Real estate rent. Rent from real estate and from personal property leased with real estate is not self-employment income. However, if you are a real estate dealer and receive rent in the course of your trade or business, include the rental income and related deductions in figuring self-employment income.

Hotels, apartments, etc. Rents received for the use or occupancy of hotels, boarding houses, or apartment houses are not rentals from real estate if services are provided for the occupants. These payments are included in figuring net earnings from self-employment. Services are generally provided for the occupants if they are primarily for their convenience and not services normally provided with the rental of rooms or space for occupancy only. Maid service, for example, is a service provided for the convenience of the occupants. However, heat and light, the cleaning of stairways, exits, and lobbies, and the collection of trash are not.

Trailer park owners. Rent received by trailer park owners who provide trailer lots, facilities, and services is rent from real estate and is not included in self-employment income unless the services provided by the owners are substantial and for the convenience of tenants. Providing services, such as city sewerage, electrical connections, and roadways are services required to maintain space for tenant occupancy and not services for the convenience of tenants. Although the operation and maintenance of a trailer park laundry facility is a service provided for the convenience of tenants, it is not, by itself, substantial.

If, however, the owners provide services for the convenience of tenants that are beyond those required for occupancy and are substantial in nature, the owner's earnings are included in self-employment income. Services for the convenience of tenants that are beyond those required for occupancy include supervising and maintaining a recreational hall provided by the park consisting of a card area, pool room, kitchen, auditorium, stage, and library; distributing a monthly newsletter to tenants; operating a laundry facility; and helping tenants buy or sell their trailers.

Sole proprietor. You own your own business and operate as a sole proprietor. Your income from your business is self-employment income.

U.S. citizens working in U.S. for foreign entity or international organization. If you are a U.S. citizen employed in the United States by a foreign government, a wholly owned instrumentality of a foreign government, or an international organization, you are subject to the self-employment tax if your employer does not deduct social security tax from your income.

International social security agreements. The United States has social security agreements with many countries to eliminate dual taxes under two social security systems. Under these agreements, you must generally pay social security taxes to only the country you live in.

The United States now has social security agreements with the following countries: Belgium, Canada, France, Germany, Italy, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. Additional agreements may be effective after this publication went to print. For more information, contact:

Social Security Administration
Office of International Policy
P.O. Box 17741
Baltimore MD 21235

Wages, salaries, and tips. Wages received for services performed as an employee and covered by social security tax or railroad retirement tax are not self-employment income. Tips received for work done as an employee are also excluded from self-employment income.

Net Self-Employment Income

Net self-employment income usually includes all business income less all business deductions allowed for income tax purposes. You must determine your net earnings from self-employment by using the same accounting method you use for income tax purposes. You must claim all allowable deductions when figuring net earnings from self-employment. Making false statements to get or to increase social security benefits may subject you to penalties.

If you have more than one trade or business, you must combine the net earnings from each business to determine your net self-employment income. A loss you incur in one business will reduce your gain in another business. You net these gains and losses only for purposes of the self-employment tax. Keep separate records for each business and file the appropriate form or schedule for each separate business.

Example. You are the sole proprietor of two separate businesses. You operate a restaurant which made a net profit of $25,000 last year. You also have a cabinet making business which had a net loss of $500 last year. You file one Schedule SE showing net self-employment income of $24,500. You must also file a Schedule C for each business—a Schedule C for the restaurant showing your net profit of $25,000, and another Schedule C for the cabinetmaking business showing your net loss of $500.

Deductions and exemptions. Your self-employment income should not be reduced by certain deductions and exemptions used to figure income tax. Specifically, do not use:

1) Deductions for personal exemptions for yourself, your spouse, or dependents,
2) The standard deduction,
3) The net operating loss deduction,
4) The foreign expropriation loss deduction,
5) Nonbusiness deductions, and
6) The self-employed health insurance deduction.

Example. You own a grocery store which reported the following items for the year:

Gross profit on sales	$87,400
Salaries	30,000
Rent	6,000
Heat, light, and air conditioning	2,400
Other expenses	1,900
Gain on sale of refrigerator	350
Fire loss on store building	1,200
Net operating loss carryover	1,000

To figure taxable income, consider all the above items. But to figure ***net earnings from self-employment,*** use only the following:

Gross profit on sales		$87,400
Expenses:		
Salaries	$30,000	
Rent	6,000	
Heat, light, and air conditioning	2,400	
Other expenses	1,900	
Total expenses		40,300
Net operating profit		$47,100

The $47,100 is your net earnings from self-employment. The refrigerator sale, the fire loss, and the net operating loss carried over from a previous year are not included in the calculation.

Figuring Self-Employment Tax

There are three steps to figure the amount of self-employment tax you owe.

1) Determine your net earnings from self-employment.
2) Determine how much of these earnings are subject to the tax.
3) Multiply that amount by the tax rate.

There are three ways to figure self-employment net earnings. These are the regular method, the farm optional method, and the nonfarm optional method. For a discussion of the farm optional method, see Publication 533 or Publication 225, *Farmer's Tax Guide.*

The nonfarm optional method is intended to permit continued coverage for self-employment tax purposes when your net profit for the year is small or you have a loss. You use the nonfarm optional method only to figure self-employment tax. Do not use it to figure your income tax.

The regular method and the nonfarm optional method differ in the way you determine net earnings. However, the kinds of excluded income or loss, the minimum and maximum income limits, and the tax rate apply to each method. The general rules for figuring self-employment tax are presented in the regular method below. This method can be figured on either *Short Schedule SE* (Section A), or *Long Schedule SE* (Section B). However, there are restrictions as to who can use the short schedule.

Tax rates. After 1989, the self-employment tax rate is 15.3%, and the 2% credit for 1989 has been replaced by the following two deductions:

- A deduction of half your self-employment tax for the year is taken as a business expense in figuring adjusted gross income. This is an income tax deduction only, and you deduct it on line 25 of your 1990 Form 1040. It is not a deduction in figuring net earnings from self-employment subject to self-employment tax.
- A deduction of 7.65% of your net earnings from self-employment is taken when figuring your self-employment tax. This deduction is allowed only in figuring self-employment tax, and you figure it on line 4 of your 1990 Schedule SE. It is not an income tax deduction.

Schedule SE. Schedule SE (Form 1040), *Social Security Self-Employment Tax,* is used to compute self-employment tax. This form is illustrated in Publication 533.

Joint returns. You cannot file a joint Schedule SE (Form 1040) even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has self-employment income, it is independently subject to the self-employment tax, and should be reported on a separate Schedule SE. If you both have self-employment income, each of you must file a separate Schedule SE (Form 1040).

Community income. If any of the income from a trade or business other than a partnership is community income under state law, it is subject to self-employment tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or business is determined by the facts in each case.

Short Schedule SE

Most taxpayers can use *Short Schedule SE,* (Section A) to figure self-employment tax.

However, the following taxpayers must use *Long Schedule SE* (Section B), discussed later.

1) Ministers, members of religious orders, or Christian Science practitioners, not taxed on earnings from these sources (with IRS consent), but who owe self-employment tax on other earnings,
2) Government employees subject only to the 1.45% Medicare part of social security tax, if wages and earnings are more than $51,300,
3) Employees of a church or church-controlled organization that elected exemption from social security taxes,
4) Individuals with tip income subject to social security tax that was not reported to their employers, and
5) Individuals who want to use one of the optional methods to figure self-employment tax.

Use the following steps to figure self-employment tax.

Step 1. Figure your net earnings from self-employment. The net income from your business or profession is generally your net earnings from self-employment. Net income is figured by subtracting all allowable business expenses and deductions from gross business income.

Step 2. After you figure your net earnings from self-employment, determine how much of your net earnings is subject to self-employment tax. Your net earnings are reduced by the new 7.65% deduction for figuring self-employment tax, and there is both a minimum and a maximum income limit.

New 7.65% deduction for figuring self-employment tax. Multiply your net earnings by 0.9235 for this new 7.65% deduction (100% − 7.65% = 92.35% or 0.9235).

Minimum income. You must have $400 or more of net earnings from self-employment after reduction by the new 7.65% deduction to be subject to the tax. If your net earnings are less than $400, you do not have to file Schedule SE (Form 1040) or pay the tax.

Maximum income. No more than $51,300 of your net earnings in 1990 is subject to any combination of self-employment tax, social security tax, or railroad retirement tax. If you have more than $51,300 in income, you pay these taxes only on $51,300.

If you have wages in 1990 that are subject to either social security or railroad retirement tax, or both, subtract the total of these wages from $51,300 to find the maximum amount subject to the self-employment tax. If your wages are subject to social security or railroad retirement tax, or both, and total at least $51,300, you do not have to pay self-employment tax.

Step 3. After you determine how much of your net earnings are subject to self-employment tax, multiply that amount by the tax rate for 1990 of 15.3% (0.153). The result is the amount of self-employment tax you owe.

Example 1. During 1990, you have $30,000 in net earnings from self-employment, and receive no wages subject to social security tax. You multiply the $30,000 by .9235 for the new 7.65% deduction (100% − 7.65% = 92.35%), and the result is $27,705. Your self-employment tax is 15.3% (0.153) of $27,705, or $4,238.87.

Example 2. During 1990, you have $60,000 in net earnings from self-employment, and receive no wages subject to social security tax. You multiply the $60,000 by 0.9235 for the new 7.65% deduction, and the result is $55,410.

Since only $51,300 of your income is subject to self-employment tax, your tax is 15.3% (0.153) of $51,300, or $7,848.90.

Example 3. During 1990, you have $50,000 in net earnings from self-employment, and receive $6,000 in wages subject to social security tax. You multiply the $50,000 by 0.9235 for the new 7.65% deduction, and the result is $46,175. Since only $45,300 ($51,300 − $6,000) of your income is subject to self-employment tax, your tax is 15.3% (0.153) of $45,300, or $6,930.90.

Example 4. During 1990, you have $20,000 in net earnings from self-employment, and receive $15,000 in wages subject to social security tax. You multiply the $20,000 by 0.9235 for the new 7.65% deduction, and the result is $18,470. Since your wages subtracted from the $51,300 maximum for 1990 is more than $18,470 ($51,300 − $15,000 = $36,300), your tax is 15.3% (0.153) of $18,470, or $2,825.91.

Fiscal year taxpayer. If you use a tax year other than the calendar year, you must use the tax rate and maximum income limit in effect at the beginning of your tax year. Even if the tax rate or maximum income limit changes during your tax year, you should continue to use the same rate and limit throughout your tax year.

Long Schedule SE

Employees of an electing church or church-controlled organization that is exempt from employer social security taxes must file *Long Schedule SE* if they have $100 or more of wages.

Government employees subject only to the Medicare part of social security tax, who also have self-employment income, must use this schedule. If their combined wages and self-employment income are more than $51,300, they must first complete the worksheet in the Schedule SE instructions.

Individuals with tip income subject to social security tax that was not reported to their employers must file Form 4137. If they have other self-employment income, they must complete *Long Schedule SE* .

The long schedule must be used to figure self-employment tax under the nonfarm optional method and the farm optional method which are explained here.

Who should use optional methods. You should use one or both of the optional methods if your net self-employment income is less than $1,600 (or even a loss), and:

1) You want to continue your social security benefit coverage,
2) You incurred child or dependent care expenses to be self-employed (this method will increase your earned income which could increase your credit), or
3) You are entitled to the earned income credit (this method will increase your earned income which could increase your credit).

If you use this method, you must pay self-employment tax, even if you are not otherwise required to do so.

Nonfarm Optional Method

The nonfarm optional method is used only for self-employment income that does not come from farming. You may use this method if you meet all the following tests.

1) Your actual net earnings from nonfarm self-employment figured by the regular method, as shown on line 29 of Schedule C (Form 1040) and line 15a of Schedule K–1 (Form 1065), are less than $1,733 (.9235 × $1,733 = $1600.43).
2) Your net earnings from nonfarm self-employment are less than two-thirds of the total gross income you made from nonfarm self-employment.
3) You are self-employed on a regular basis. This means that your actual net earnings from self-employment are $400 or more in at least 2 of the 3 tax years before the one for which you use this method.
4) You have not previously used this method more than 4 years (there is a 5 year lifetime limit).

Gross income of $2,400 or less. If your gross income from all nonfarm trades or businesses is $2,400 or less, and you meet the four tests in the preceding paragraph, you may report two-thirds of the gross income from your nonfarm business as net earnings from self-employment.

Example 1. Ann Green had actual net earnings from self-employment of $400 or more in 1988 and 1989 from running a craft store. Thus, she meets the test for being self-employed on a regular basis. Her earnings from the craft business in 1990 are as follows:

Gross income	$2,100
Net earnings	$1,200

Because her actual net earnings from self-employment are less than $1,600 and less than two-thirds of her total gross nonfarm income, Ann either may report her actual net earnings of $1,200 for 1990 or she may use the optional method to report $1,400 (two-thirds of $2,100).

Example 2. Assume that in Example 1 Ann Green has gross income of $1,000 and her net earnings are $800. Ann must report her actual net earnings of $800. She may not use the optional method because her actual net earnings are not less than two-thirds of her gross income.

Example 3. Assume that in Example 1 Ann has a net loss of $700. In this situation, she may choose to report $1,400 (two-thirds of $2,100) as her net earnings under the optional method.

Gross income of more than $2,400. If your gross income from all nonfarm trades or businesses is more than $2,400 and you meet the four tests for using the nonfarm optional method, you may report $1,600 as your net earnings from nonfarm self-employment.

Example 1. John White runs an appliance repair shop. His net earnings from self-employment in 1987 were $8,500; in 1988, $10,500; and in 1989, $9,500. Thus, he meets the test for being self-employed on a regular basis. His earnings in 1990 are as follows:

Gross income	$12,000
Net earnings	$ 1,200

Because his net earnings from self-employment ($1,200) are less than $1,600 and less than two-thirds of his gross nonfarm income, John may either report $1,600 as his net earnings from self-employment for 1990, or he may report $1,200 under the regular method.

Example 2. Assume that in Example 1 John's actual net profit for 1990 is $1,700. He must report the full $1,700 under the regular method. He may not use the optional method because his actual net earnings from self-employment are not less than $1,600.

Example 3. Assume that in Example 1 John has a net loss of $700 for 1990. He may use the optional method and report $1,600 as his net earnings from self-employment.

Figuring the tax. If your net earnings under the nonfarm optional method are $400 or more, multiply the net earnings figure by the tax rate for 1990 (15.3%). The result is the amount of self-employment tax you owe.

Child and dependent care credit. If you use either of the optional methods to figure your net self-employment income, you must use the amount of your self-employment income as figured on either line 12 or line 14, as appropriate, of Long Schedule SE (Form 1040), for your credit for child and dependent care expenses. You will have to pay the self-employment tax even if your actual net earnings are less than $400. For more information, see Publication 503, *Child and Dependent Care Expenses.*

Earned income credit. If you use either of the optional methods to figure your net self-employment income, you must use the amount of your self-employment income as figured on either line 12 or line 14, as appropriate, of Long Schedule SE (Form 1040) for your earned income credit. You will have to pay the self-employment tax even if your actual net earnings are less than $400. To find out if you qualify, complete the *Earned Income Credit Worksheet* in the Form 1040 instructions.

33. Employment Taxes

Important Changes for 1990

New wage maximums and tax rates for social security taxes. In 1990, the tax rate for social security taxes is 7.65% for both the employee and the employer (a total of 15.3%) on wages up to $51,300. The 7.65% tax is a total of 6.2% for social security (old-age, survivors, and disability insurance), and 1.45% for Medicare (hospital insurance).

In 1991, the tax will remain at 7.65% but the maximum wages subject to the social security portion (6.2%) increase to $53,400, while the maximum wages subject to the Medicare portion (1.45%) increase to $125,000.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% through 1991.

New federal tax deposit penalties. After 1989, the penalty for a late tax deposit is based on the length of time the deposit is late. See *Penalties.*

New $100,000 deposit rule. After July 31, 1990, undeposited taxes that reach $100,000 or more in any eighth-monthly deposit period must be deposited on the next banking day. However, you are still required to make deposits within 3 banking days when undeposited taxes reach at least $3,000 at the end of an eighth-monthly deposit period. See *Deposits.*

If you have one or more employees, you will probably be required to withhold federal income tax from their wages. You also may be subject to social security taxes under the Federal Insurance Contributions Act (FICA) and federal unemployment tax under the Federal Unemployment Tax Act (FUTA).

For additional information about what constitutes taxable wages, the treatment of special types of employment and payments, and similar matters, get a free copy of Publication 15 (Circular E), *Employer's Tax Guide,* from the Internal Revenue Service (IRS).

Every employer subject to employment taxes is required to have an ***employer identification number.*** If you have not applied for your identification number, you should get an application, Form SS–4, *Application for Employer Identification Number,* from the nearest office of the Internal Revenue Service or the Social Security Administration. See *Taxpayer Identification Number* in Chapter 1.

Who Are Employees?

Before you can know how to treat payments you make for services rendered to you, you must first know the business relationship that exists between you and the person performing those services. The person performing the services may be:

- An independent contractor;
- A common-law employee;
- A statutory employee; or
- A statutory nonemployee.

Independent contractors. People such as lawyers, contractors, subcontractors, public stenographers, auctioneers, etc., who follow an independent trade, business, or profession in which they offer their services to the general public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if you, the employer, have the right to control or direct only the result of the work and not the means and methods of accomplishing that result.

You do not have to withhold or pay taxes on payments you make to independent contractors.

Common-law employees. Under common law rules, every individual who performs services subject to the will and control of an employer, as to both ***what*** must be done and ***how*** it must be done, is an employee. It does not matter that the employer allows the employee discretion and freedom of action, so long as the employer has the ***legal right*** to control both the method and the result of the services.

Two usual characteristics of an employer-employee relationship are that the employer has the right to discharge the employee and the employer supplies tools and a place to work.

If you have an employer-employee relationship, it makes no difference how it is described. It does not matter if the employee is called an employee, or a partner, co-adventurer, agent, or independent contractor. It does not matter how the payments are measured, how they are made, or what they are called. Nor does it matter whether the individual is employed full time or part time.

No distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. An officer of a corporation is generally an employee, but a director is not. An officer who does not perform any services, or performs only minor services, and who neither receives nor is entitled to receive any pay is not considered an employee.

You may have to withhold and pay taxes on wages you pay to common-law employees.

Statutory employees. If an individual who works for you is not an employee under the common law rules, you do not have to withhold federal income tax from that individual's pay. However, for social security taxes, the term ***employee*** includes any individual who works for you in one of the following four categories:

1) A driver who distributes meat products, vegetable products, fruit products, bakery products, or beverages (other than milk), or picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2) A full-time life insurance salesperson.
3) An individual who works at home on materials or goods which you supply and which must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
4) A full-time traveling or city salesperson, who works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyers' business operations.

Social security tax. Individuals within any of these categories are employees for social security tax purposes if:

1) The service contract states or implies that almost all of the services are to be performed personally by them;
2) The individual has little or no investment in the equipment and property used to perform the services (other than an investment in transportation facilities); and
3) The services are performed on a continuing basis.

Federal unemployment tax. For federal unemployment tax purposes, the term ***employee*** means the same as it does for social security tax purposes, except that it does not include insurance salespersons or individuals who work at home.

Reporting payments to statutory employees. Furnish a Form W–2 to a statutory employee, and check *Statutory employee* in box 6. Show your payments to the employee as other compensation in box 10. Also, show social security tax withheld in box 11, and social security wages in box 12. The statutory employee can deduct his or her expenses from the payments shown on Form W–2 and, after 1989, will report earnings as a statutory employee on line 1 of Schedule C.

Statutory nonemployees. Two categories of statutory nonemployees have been established: direct sellers and licensed real estate agents. They are treated as self-employed if:

1) Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked; and
2) Their services are performed under a written contract providing that they will not be treated as employees for federal tax purposes.

For more information on direct sellers, get Publication 911, *Tax Information for Direct Sellers.*

Employer-employee relationship. In doubtful cases, the facts will determine whether or not there is an actual employer-employee relationship. For an in-depth discussion and examples of the common law employer-employee relationship, see *Who Are Employees?* in Publication 937, *Business Reporting.*

If you want the IRS to determine whether a worker is an employee, file Form SS–8 with the District Director for the area in which your business is located.

Worker not treated as an employee. If you treat a worker other than as an employee (for example, as an independent contractor) and you have no reasonable basis for doing so, you will have to pay employment taxes for that worker.

Relief provisions. If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required federal tax returns, including information returns, on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977. For more information, see Revenue Procedure 85–18 in Internal Revenue Cumulative Bulletin 1985–1, page 518.

Technical service specialist. This relief provision does not apply to a worker who provides services for a client as a technical service specialist under an arrangement between a taxpayer, such as a technical services firm, and the client. A technical service specialist is an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. (A taxpayer who directly contracts with a technical service specialist to provide services for itself rather than for a third party may still be entitled to the relief provision.) This rule does not automatically convert technical service specialists to employees for employment tax purposes. The common-law standards control whether the specialist is treated as an employee or an independent contractor.

Leased employees. Under certain circumstances, a corporation furnishing workers to various professional people and firms is the employer of those workers for employment tax purposes. For more information, see *Leased employees* in Publication 937.

Income Tax Withholding

You must generally withhold income tax from wages you pay employees if their wages for any payroll period exceed the amount of their withholding allowances for that period. The amount to be withheld is figured separately for each payroll period.

A ***payroll period*** is the period of time for which you usually make a payment of wages to an employee. ***Regular*** payroll periods can be daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannually, or annually. A ***miscellaneous*** payroll period is any other period. Sundays and holidays are included in computing the number of days in a miscellaneous payroll period.

You should not withhold tax from the wages of employees who claim exemption from withholding on Form W–4, *Employee's Withholding Allowance Certificate.* Only employees who did not have to pay income tax last year and do not expect to pay any this year may claim exemption from withholding. Employees who claim exempt status on Form W–4 must renew their status by filing a new Form W–4 with you by February 15 of each year.

In addition to wages, other payments or benefits you give to your employees may or may not be subject to withholding, as discussed next.

Withholding and Reporting Payments Other than Wages

Supplemental unemployment benefits. If you pay supplemental unemployment benefits to a former employee, all or part of the payments may be taxable. You should withhold income tax on the taxable part of the payments made to an employee who is involuntarily separated because of a reduction in force, discontinuance of a plant or operation, or other similar condition. It does not matter whether the separation is temporary or permanent.

Withholding on taxable supplemental unemployment benefits must be based on the withholding certificate the employee gave you.

Annuity or pension payments. Pension and annuity payments are generally subject to income tax withholding unless the recipient elects not to have tax withheld. See *Annuity and pension payments* in Publication 937 for more information.

Sick pay paid by third party. Employees may file Form W–4S, *Request for Federal Income Tax Withholding from Sick Pay,* with third-party payers of sick pay to ask that federal income tax be withheld. For more information about sick pay paid by third parties, get Circular E.

Leave sharing plans. If you establish a leave sharing plan for your employees that allows them to donate leave to other employees for medical emergencies, the amounts paid to the recipients of the leave are considered wages. These amounts are includible in the gross income of the recipients and are subject to social security and federal unemployment taxes, and income tax withholding. Do not include these amounts in the income of the donors.

Bonuses and awards. If you pay bonuses, make taxable awards, or pay other supplemental wages to an employee, you must withhold income tax from the payment. If you add the payment to the employee's regular wages, you may figure the income tax to be withheld as if the total of the supplemental and regular wages were a single wage payment for the regular payroll period. However, if you withhold tax on the regular portion at the appropriate rate and specifically indicate on your payroll records the amount of each payment, you may withhold on the supplemental portion using a flat 20% rate without considering withholding allowances or the amount of regular wages.

If supplemental wages are paid separately, you may figure the tax to withhold by adding the supplemental wages to the regular wages for either the current payroll period or the last preceding payroll period within the same calendar year. If you have already withheld tax from the regular wages, you may figure the tax to withhold by using a flat rate of 20% without considering withholding allowances and without referring to a regular wage payment.

Reimbursement for meals, entertainment, and lodging. If your employee adequately accounts to you for his or her business expenses for meals, entertainment, and lodging, this reimbursement is not subject to social security taxes, federal unemployment tax, or income tax withholding, and it is not included on Form W–2. (However, you can deduct only 80% of business-related meal and entertainment expenses on your income tax return. See chapter 15.)

You will generally have to withhold federal income tax and social security taxes and pay the federal unemployment tax on any reimbursement or other expense allowance and report it as wages on your employees' Form W–2 if you:

1) Do not require your employees to, or they do not, adequately account to you for their expenses, or
2) Allow your employees to keep, or they keep, any excess reimbursement or allowance over the expenses adequately accounted for.

However, prior to July 1, 1990, if you reasonably believe that your employee used an amount for business purposes, it is not subject to income tax withholding, social security taxes, and federal unemployment tax even though it was not substantiated or was an unreturned excess reimbursement. Report the amount in box 10 of Form W–2 as other compensation not subject to withholding.

If you give your employee a per diem or other fixed allowance for business expenses, your employee is considered to have adequately accounted to you for the amount of the expenses covered by this arrangement up to the amounts that have been specified by the federal government (the standard mileage rate for auto expenses and the government per diem rate shown in Circular E). Other than the amount of these expenses, your employee's business expenses (for example, the business purpose of the travel or the number of business miles driven) must be substantiated. For more information get Circular E, *Employer's Tax Guide.*

Reimbursement for mileage. If you reimburse your employees for business mileage at a rate above the standard mileage rate set by the IRS of 26 cents a mile, report the amount up to the standard mileage rate as nontaxable income in box 17 of Form W–2, and the excess amount over the standard mileage rate in other compensation in box 10 of Form W–2. However, the reimbursement is not subject to social security and federal unemployment taxes, or income tax withholding.

After 1989, if you reimburse your employees with a mileage allowance that combines periodic fixed rate payments for items such as depreciation and insurance with periodic variable rate payments for items such as gas and maintenance—a fixed and variable rate (FAVR) allowance, you do not have to report the excess over the standard mileage rate as other compensation in box 10 of Form W–2. For more information, on a FAVR allowance, see Revenue Procedure 90–34 in Internal Revenue Cumulative Bulletin 1990–1, page 552.

Excessive termination payments (golden parachutes). A golden parachute is a contract entered into by a corporation and key personnel under which the corporation agrees to pay certain amounts to the key personnel in the event of a change in ownership or control of the corporation. Payments under golden parachute contracts, like any termination pay, are subject to social security and federal unemployment taxes, and income tax withholding.

Beginning with payments under contracts entered into or renewed after June 14, 1984, no deduction is allowed to the corporation for excess parachute payments. The employee is subject to a 20% nondeductible excise tax to be withheld by the corporation on all excess payments. The payment is generally considered an excess parachute payment to the extent it equals or exceeds three times the average compensation of the recipient over the previous 5–year period. Get *Circular E* for information on reporting golden parachute payments.

Exempt payments. Payments from a small business corporation are exempt from the golden parachute rules. A small business corporation is generally a corporation that meets the requirements for electing S corporation status (see Chapter 30). Also exempt are payments from a corporation that, immediately before a change in control, has no stock that is readily tradable on an established securities market or otherwise if: (1) the payments were approved by a vote of shareholders owning more than 75% of the voting power of the outstanding stock, and (2) there was adequate disclosure of all material facts concerning such payments. For more information, see *Exempt payments* in Publication 937.

Interest-free and below-market interest rate loans. If an employer loans an employee (or an independent contractor) more than $10,000 at less than the applicable federal interest rate, the employer is deemed to have paid additional compensation to the employee equal to the difference between the applicable federal interest rate and the interest rate charged.

This amount treated as additional compensation to the employee is also treated as a payment of unstated interest by the employee to the employer that is includible in the employer's income. Thus, it is deductible by the employee as an interest expense and by the employer as a business expense. This additional compensation to the employee is subject to social security and federal unemployment taxes, but not to income tax withholding. Include it in compensation on Form W–2 (or Form 1099–MISC for an independent contractor). For more information, see Chapter 6 in Publication 535, *Business Expenses.*

Employee fringe benefits. Certain fringe benefits that an employer provides to an employee are excluded from the employee's gross income. They are not subject to social security and federal unemployment taxes, or income tax withholding. See Chapter 10.

Cafeteria plans. Cafeteria plans must be written benefit plans under which all participants are employees who may choose from among cash and certain qualified benefits. If the employee elects qualified benefits, employer contributions are excluded from his or her wages if the benefits are excludible from gross income under a specific section of the Internal Revenue Code (other than scholarship and fellowship grants under section 117, educational assistance under section 127, and employee fringe benefits under section 132).

The cost of group term life insurance that is includible in income only because the insurance exceeds $50,000 of coverage, or is on the life of the employee's spouse or children, is considered a qualified benefit under a special rule. Benefits under a cafeteria plan are not subject to social security and federal unemployment taxes, or income tax withholding. For more information, see *Cafeteria Plans* in Chapter 10.

Form W–4 Withholding Allowances

> *Note:* You should make new 1991 Forms W–4 available to your employees, and encourage them to check their income tax withholding situation for 1991. Those employees who owed a large amount of tax or received a large refund for 1990 may need to file a new 1991 Form W–4.

In general, an employee can claim withholding allowances equal to the number of exemptions the employee will be entitled to in figuring income tax on the annual return. An employee may also be able to claim a special withholding allowance and allowances for deductions and credits. See *Special withholding allowance* and *Additional withholding allowances*, later.

You should ask each new employee to give you a Form W–4 on or before his or her first day of work. This certificate is effective for the first payment of wages and will last until the employee files a new one unless the employee claims exemption from withholding. The certificate must include the employee's social security number.

If an employee does not give you a Form W–4, you must withhold tax as if the employee were a single person who has claimed no withholding allowances. Married employees (and widows and widowers qualified to figure their income tax as married persons) who have not indicated on Form W–4 that they are married will be treated as single persons for withholding purposes.

Change in allowances or marital status. An employee who wants to change the number of allowances claimed or show a change in marital status should file a new Form W–4. Near the end of each year, you should ask each of your employees to file a new Form W–4 for the following year if there has been a change in allowances or marital status since the last Form W–4 was filed. See *Effective date of Form W–4*, later, under *Additional withholding allowances*.

Employee with two jobs. An employee who holds two jobs at the same time, and claims all withholding allowances on the Form W–4 filed with one employer, must claim zero allowances on the Form W–4 filed with the second employer.

Married employees. You should inform your married employees that if a husband and wife both work, they can divide their allowances any way they like. But one spouse may not claim an allowance claimed by the other.

Exempt employees. An employee can claim an exemption from income tax withholding on Form W–4 if he or she had a right to a refund of all federal income tax withheld last year because of no income tax liability, and expects the same situation to exist this year. Student status does not automatically exempt the employee from withholding. An employee who can be claimed as a dependent by someone else usually cannot claim this exemption if he or she has nonwage income and that income plus wages are expected to be more than $500. An employee who has claimed exemption from withholding and later discovers he or she will incur tax liability must give you a new Form W–4 within 10 days.

An employee who wants to continue claiming exemption from withholding must file a new Form W–4 by February 15 each year. If the employee does not do so, you must withhold tax as if the employee is single with zero withholding allowances.

Special withholding allowance. An employee can claim a special withholding allowance if the employee is single and works for only one employer, or is married and works for only one employer and the employee's spouse is not employed. The employee may still claim this allowance if the total wages earned on other jobs by the employee or the employee's spouse (or both) is 10% or less of the combined total wages.

Additional withholding allowances. An employee can claim additional withholding allowances on Form W–4 when the employee has a large amount of estimated deductions, credits, or losses. For more information, see the instructions for Form W–4. If an employee has estimated credits that are not covered by the Form W–4 calculations, he or she can also use an alternative method to figure withholding allowances. For more information, see Notice 88–42 in Internal Revenue Cumulative Bulletin 1988–1, page 527.

Your employee who is entitled to claim additional allowances can claim them only by filing a new Form W–4 with you and completing the table on that form which is used to figure the number of additional allowances. The additional allowances remain in effect until the employee files a new Form W–4 with you. Each employee must file a new form if the number of allowances he or she is entitled to claim decreases to less than the number the employee is now claiming.

Effective date of Form W–4. You must put a new Form W–4 into effect no later than the start of the first payroll period ending on or after the 30th day from the date that you receive it. If you pay wages without regard to a payroll period, you must put the new Form W–4 into effect no later than the first payment of wages on or after the 30th day from the date that you receive it.

Repayment or reimbursement. If an employee gives you a new Form W–4 claiming additional withholding allowances, you may not reimburse the employee for income taxes collected during the year before the effective date of the new Form W–4. But you may reimburse the employee for income taxes you overcollected on or after the effective date if you did not take the new certificate into account.

Additional withholding. If an employee determines that his or her income tax liability for the year will be more than the total amount to be withheld, the employee may authorize you, if you agree, to withhold more tax than required. The agreement must be in writing and may be in any form you want. It will be effective for any period mutually agreeable to you and your employee. You can use Form W–4 for such an agreement.

A married employee may also have tax withheld at the higher "single" rate by checking the appropriate box on Form W–4.

Invalid withholding certificate. Any alteration of, or unauthorized addition to, a withholding certificate makes it invalid. If an employee indicates to you, either orally or in writing, that the information on the withholding certificate is not valid, the certificate will be invalid even if it is not yet in effect. If you realize the certificate is invalid, then you must ask your employee to furnish a new one. If the employee does not comply, you must withhold from the employee the same amount you would withhold from a single person claiming no exemptions. However, if a prior certificate is still in effect, you should withhold according to that certificate.

If you have reason to believe that a withholding certificate has incorrect information, you should advise the District Director.

Filing Form W–4 with the Internal Revenue Service. You must send the IRS a copy of any Form W–4 received from an employee who is still employed by you at the end of the quarter if:

1) The employee filing it claims 11 or more withholding allowances; or
2) The employee filing it claims exemption from income tax withholding, but the employee's wages are more than $200 a week.

Copies of the Forms W–4 that must be submitted because of either of the above conditions should be sent along with your quarterly employment tax returns, Forms 941 or 941E. You may send them more often if you like. But if you do, please include a statement giving your name, address, employer identification number, and the number of forms you are sending. If you would like to report this material on magnetic tape, you should get a copy of Revenue Procedure 90–9. It is published in Internal Revenue Cumulative Bulletin 1990–1, page 460.

Figuring Withholding

You should figure withholding on gross wages before any deductions for social security tax, pension, union dues, insurance, etc., are made. You may figure the withholding by any of several methods, the most common of which are the percentage method and the wage bracket method.

The percentage method must be used for quarterly, semiannual, or annual payroll periods.

If you have a choice between the percentage method or the wage bracket method, you may choose to use a different one for each employee and each paycheck.

Circular E contains the applicable tables and more detailed instructions for using both of these withholding methods. Also, see Publication 493, *Alternative Tax Withholding*

Methods and Tables, for a discussion of other methods you may use to compute withholding taxes.

Social Security Taxes

The Federal Insurance Contributions Act (FICA) provides for a federal system of old age, survivors, disability, and hospital insurance. This system is financed through social security taxes, also known as FICA taxes. Social security taxes are levied on both you and your employees (however, see *Children employed by parents*, later). You, as an employer, must collect and pay the employee's part of the tax. You must withhold it from wages in much the same way as income tax, described earlier. You are also liable for your own (employer's) share of social security taxes.

Tax rates. Your tax rate for 1990 is 7.65% and your employee's tax rate is also 7.65%.

Tax limit. The wages subject to these taxes are limited to the first $51,300 of wages you pay each employee during calendar year 1990.

Generally, meals, lodging, clothing, services, and other payments in kind are subject to the same social security taxes as wages paid in cash.

No withholding allowances are permitted for social security taxes. A table showing the amount to be withheld from the employee is in Circular E.

Successor employer. If you acquire all or substantially all the property used in the business of another employer, or a unit of that employer's business, you may, in determining the annual limit for each of your new employees who worked for the other employer, include the wages the previous employer paid to the employee.

Example. Early in 1990, you bought all of the assets of a bakery business from James Martin. Sue Brown, who had been employed by James Martin and received $2,000 in wages before the date of purchase, continued to work for you. You and Sue Brown are subject to social security taxes on only the first $49,300 ($51,300 − $2,000) of wages you pay her during the rest of the calendar year.

Employee's social security number. If some of your employees do not have a social security number and have not applied for one, you should tell them to submit an application on Form SS–5, *Application for a Social Security Card*, to the nearest Social Security office. Form SS–5 can be obtained from any Social Security office.

If any of your employees are under 18, they must furnish evidence of age, identity, and U.S. citizenship along with the Form SS–5. Employees who are 18 years old or older must appear in person with this evidence at a Social Security office.

Sick pay. Employers and third-party payers, such as insurance companies, must withhold employee social security taxes and pay employer social security taxes on most sick pay payments. In general, sick pay is any amount paid by an employer to an employee because of the employee's sickness or injury.

Third-party sick pay is any amount paid by a third party to an employee in place of wages for any period the employee is absent due to sickness or injury. Liability for paying the employer portion of the social security tax, however, shifts from the third party to the employer for whom the employee normally works if the third party promptly:

1) Withholds the employee share of social security tax;
2) Deposits such tax; and
3) Notifies the employer of the sick pay payment.

The following kinds of payments are not subject to social security taxes:

1) Payments made more than 6 months after the last calendar month the employee worked.
2) Payments received under worker's compensation law.
3) Payments, or portions of payments, attributable to the employee's contribution to a sick pay plan.
4) Most payments made to a state or local government employee. The third-party payer should contact the state or local government employer for instructions.
5) Payments made for medical care
6) Payments (generally for injury) not related to absence from work.

Deferred compensation arrangements. Employer contributions to a cash or deferred compensation arrangement that is part of a qualified profit-sharing or stock bonus plan are included in social security wages. This will apply even if the contributions are not includible in the employees' gross incomes. See Publication 937 for more information.

Concurrent employment by related corporations. If two or more related corporations employ the same individual at the same time and pay this individual through a common paymaster, which is one of the corporations, the corporations are considered a single employer. They have to pay, in total, no more in social security taxes than a single employer would.

Each corporation must pay its own part of the employment taxes and may deduct only its own part of the wages. The deductions will not be allowed unless the corporation reimburses the common paymaster for the wage and tax payments.

Inactive duty uniformed reservists. The pay of uniformed reservists for inactive duty training (generally weekend training and drills) is subject to social security taxes.

One spouse employed by another. Wages you pay to your spouse for services in your trade or business are subject to social security taxes. Wages you pay to your spouse for service that is not in your trade or business, however, such as domestic service in your private home, are exempt from social security taxes.

Children employed by parents. Wages you pay to your child 18 years of age or older for services in your trade or business are subject to social security taxes. Wages you pay to your child under the age of 21 for service that is not in your trade or business, however, such as domestic service in your private home, are exempt from social security taxes.

Group-term life insurance. The cost of group-term life insurance you provided to an employee for coverage over $50,000, or for coverage that discriminated in favor of the employee, is subject to social security taxes. This taxable insurance cost can be treated as though paid by the pay period, by the quarter, or on any basis so long as the cost is treated as paid at least once a year.

The cost of group-term life insurance for your employees who quit or retired before 1989 is not subject to social security taxes. However, if such former employees later return to work, their group-term life insurance is subject to social security taxes.

State and local government employees. State and local government employees hired after March 31, 1986, are generally subject to the hospital insurance portion of social security taxes. These employees can use their state or local government employment in determining eligibility for Medicare benefits.

The tax and benefits do not generally apply to individuals hired to relieve unemployment; to patients or inmates working in hospitals, homes, or other institutions; to temporary workers hired for fire, snow, flood, or similar emergencies; or to certain student employees of hospitals of the District of Columbia government.

States are no longer responsible for collecting social security contributions from local governments and reporting them to the Social Security Administration. State and local government employers who have a section 218 agreement under the Social Security Act for coverage of employees under social security now report their employees' wages to IRS on Form 941 (instead of Form 941E). They deposit the applicable taxes with IRS under the deposit rules for Form 941.

Paying Social Security Taxes and Withheld Income Tax

Social security taxes and withheld income tax are reported and paid together. The following sections discuss some rules that apply equally to both types of tax.

Employee Tips

Your employees must report to you each month cash tips of $20 or more that they receive while on the job. This includes tips received directly from customers and those that charge customers add to the bill and you paid over to the employee. However, no report need be made for any month in which the tips were less than $20. Otherwise, they should be reported every month regardless of the total wages and tips the employee receives for the year. The written report must be made by the 10th day of the month after the month the tips are received. It should show:

1) The name, address, and social security number of the employee;
2) The name and address of the employer;
3) The calendar month or period covered by the statement; and
4) The total amount of the tips the employee received during the period covered by the statement.

Tips received by your employees in December 1989, and reported to you in January 1990, are considered income in 1990.

Form 4070, *Employee's Report of Tips to Employer*, available from the IRS, may be used for reporting tips.

So-called ***gratuities*** collected by a club or other establishment through mandatory charges added to its members' bills are considered wages. These amounts are subject to both employer and employee taxes under social security, the employer tax under federal unemployment, and income tax withholding.

If you operate a ***large food or beverage establishment,*** additional tip reporting requirements may apply to you. See *Tip Reporting and Allocation Rules* in Publication 937 for a detailed discussion of those requirements.

Both income tax and employee and employer social security taxes apply. You must collect both employee social security tax and income tax on tips reported by an employee. You can withhold these taxes either from wages due the employee or from other funds the employee makes available. You must also pay the employer portion of the social security tax on tips reported by an employee. You should stop collecting ***employee*** social security tax and paying ***employer*** social security tax when the employee's combined wages and tips total $51,300 for 1990.

You are not required to withhold or pay on tips that are not reported to you.

Income tax withholding applies for the entire year, even if the social security limits have been reached.

How to figure withholding on tips. If your employees get both regular wages and tips, you can, in figuring the income tax to withhold, either:

1) Treat the tips as part of the employee's current or preceding wage payment and use the regular graduated withholding rates; or
2) If income tax has already been withheld from the regular wage payment, determine the tax to withhold from tips by using a flat 20% rate.

Pooling or splitting of tips. Employees who participate in a tip-splitting or tip-pooling arrangement must report to their employer only the tips they actually receive and keep. They may use Form 4070 or any other form provided by the employer.

Example. A restaurant pays its waiter $400 in charged tips. The waiter splits the tips with the busboy, giving the busboy one-fourth. The waiter reports to the employer only the $300 he kept. The busboy reports the $100 he received from the waiter. Both the waiter and the busboy may use Form 4070 to make their reports.

Form W-2. Employers must report on Form W-2 an employee's compensation, including tips reported by the employee to the employer.

Liability for Tax Withheld

You are required by law to deduct and withhold income and social security taxes from the salaries and wages of your employees. ***You are liable for the payment of these taxes to the federal government whether or not you collect them from your employees.*** If, for example, you deduct less than the correct tax from your employees' wages, you are still liable for the full amount.

Liability of third parties. Any lender, surety, or other third party who pays wages directly to the employees of an employer, or to the employee's agent, is responsible for any required withholding on those wages. This includes income tax withholding, social security, and railroad retirement withholding taxes. The third party also is liable for any interest and penalties accruing on these accounts.

If a third party supplies funds to an employer so that the employer can pay the employees' wages, and if the third party knows that the employer will not pay or deposit the taxes that are required to be withheld when due, then the third party must pay the taxes withheld from the employees' wages but not paid by the employer. However, the third party does not have to pay more than 25% of the amount that is specifically supplied for paying wages. The third party supplier must also pay interest on the taxes if they are paid after the due date of the employer's return.

Third parties are liable only for payment of the employees' part of the payroll taxes. They are not liable for the employer's part. The employer must file an employment tax return for wages that he or she or a third party pays, and must furnish statements to employees of wages paid and taxes withheld. The employer also remains liable for any withholding taxes not paid by the third party.

How to pay withheld tax. Third parties who pay employment taxes must file two copies of Form 4219, *Statement of Liability of Lender, Surety, or Other Person For Withholding Taxes Under Sec. 3505 of the IRC.* A separate set of forms must be filed for each employer and calendar quarter.

Form 4219 must be filed with the IRS Service Center where the employer for whom wages were paid, or funds were supplied, files federal employment tax returns.

Each Form 4219 should be accompanied by a check or money order made payable to the IRS. To avoid interest, payment should be made on or before the due date of the employer's federal employment tax return.

Tax Returns

Generally, social security (FICA) taxes and withheld income tax are reported together on Form 941, *Employer's Quarterly Federal Tax Return.* However, there are three exceptions:

1) If your employees are agricultural workers, use Form 943, *Employer's Annual Tax Return for Agricultural Employees.*
2) If your employees do household work in your private nonfarm home—for example, child care, housekeeping, or gardening work—use Form 942, *Employer's Quarterly Tax Return for Household Employees.*
3) If your employees are not covered by social security tax, use Form 941E, *Quarterly Return of Withheld Federal Income Tax and Hospital Insurance (Medicare) Tax.*

When to file returns. Form 943 is an annual return due one month after the calendar year ends. The other forms are quarterly returns due one month after the end of each calendar quarter. The periods covered by these forms are the same whether you use a fiscal year or the calendar year as your tax year. The due dates are:

Return and Period	Due Date
Form 943: Calendar year	January 31
Forms 941, 941E, and 942:	
1st quarter:	
January—February—March	April 30
2nd quarter:	
April—May—June	July 31
3rd quarter:	
July—August—September	October 31
4th quarter:	
October—November—December	January 31

However, if you must deposit the tax (see following discussion) and you deposit it on time and in full, you are given an extra 10 days to file the return:

Return and Period	Due Date
Form 943: Calendar year	February 10
Forms 941 and 941E:	
1st quarter:	
January—February—March	May 10
2nd quarter:	
April—May—June	August 10
3rd quarter:	
July—August—September	November 10
4th quarter:	
October—November—December	February 10

If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next day that is not a Saturday, Sunday, or legal holiday. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

Seasonal or intermittent employers. If you are a seasonal or intermittent employer, you do not have to file Form 941 or Form 941E when you have paid no wages during a quarter. However, you must check the seasonal filer box on Form 941, or the intermittent filer box on Form 941E, on each return you file so IRS will not expect a return each quarter.

Paying the tax. When you pay social security and withheld income tax—whether through deposits or with your return—you should write the following information on your check or money order:

1) Your employer identification number;
2) The type of tax you are paying; and
3) The period covered by the payment.

Penalties. If you pay your taxes late, you may have to pay a penalty as well as interest on any overdue amounts. There are also both civil and criminal penalties for intentionally not paying taxes, and for intentionally filing a false tax return or filing no return at all.

Deposits

You generally will have to make deposits of social security taxes and withheld income tax before the return is due. You must deposit both your part and your employees' part of social security taxes. Deposits are not required for taxes reported on Form 942, *Employer's Quarterly Tax Return for Household Employees.* For Form 942, you should pay the tax when you file the return.

Figuring deposits. Each return period is divided into a number of shorter deposit periods. Whether or not you must make a deposit for a particular period depends on the amount of tax you owe at the end of the period. If the tax you owe has reached a certain amount, a deposit is required.

If by the end of a deposit period the tax you owe has not reached the amount requiring a deposit, it is carried over and added to the tax for the next period. If the total tax at the end of that period still has not reached the amount requiring a deposit, it will all be carried over again to the next period—and so on until either a deposit is required or the return period ends. Once a tax amount requiring a deposit is reached, that amount is not considered when figuring whether any future deposits are required.

Deposits are figured separately for each return period—a calendar quarter for Forms

941 and 941E and a calendar year for Form 943. Do not add the tax owed for one return period to the tax owed for another return period when figuring deposits.

Deposit rules. Each month of the return period is divided into eight deposit periods. These periods end on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and last day of every month. Whether you must deposit the social security and withheld income taxes you owe at the end of a deposit period depends on the following rules:

1) ***New $100,000 rule.*** After July 31, 1990, if your undeposited taxes reach $100,000 or more in any eighth-monthly deposit period, you must deposit at least 95% of such taxes on the next banking day. If, by the end of that same eighth-monthly period, your additional undeposited taxes reach at least $3,000 but less than $100,000, you must deposit at least 95% of these additional taxes within 3 banking days after the end of that period. See Schedule B (Form 941), *Supplemental Record of Federal Tax Liability,* for more information, and use that schedule to report your tax liability if it is $100,000 or more.
2) ***$3,000 rule.*** If the tax you owe is $3,000 or more at the end of any of the eight deposit periods during the month (including tax from earlier deposit periods in the month), you must deposit at least 95% of what you owe within three banking days. You must then make up the difference in another deposit later. If the deposit is triggered during the last month of the return period, make up the difference no later than the end of the next month, as required by rule (4) below. If the deposit is triggered during any other month of the return period, make up the difference no later than the first deposit that is required after the 15th of the next month.
3) ***$500 rule.*** If the tax you owe is $500 or more at the end of the month, you must deposit all of it by the 15th of the next month. If your tax is less than $500, you may carry it over to the next month. This rule does not apply if the $3,000 rule applies during the same month.
4) ***End-of-return-period rule.*** If, at the end of the return period, you have undeposited taxes that do not come under the other rules, deposit them by the end of the next month. Include any underpayments yet to be deposited under the $3,000 rule. If the total is less than $500, you can either deposit the taxes or pay them with your return.

Example. In 1991, Jim Black's first deposit is for the period ending January 31. On that date he owes a total of $2,900 in FICA and withheld income tax. Because he is not required to make a deposit for any other period in January, this amount triggers a deposit under the $500 rule. Jim plans to mail in his deposit around February 11, in time to arrive before the February 15 due date.

For the next deposit period ending February 3, Jim's FICA and withheld income tax liability stands at $3,250. But $2,900 of this amount has already triggered a deposit requirement. He therefore excludes it when figuring whether a deposit is required. Because the remaining $350 is not enough to trigger a deposit, He carries it over to the next deposit period.

If Jim had been required to make a deposit for an earlier period in January, the $2,900 he owes at the end of the month would not trigger a deposit. The $3,250 owed on February 3 would then trigger a 3–day deposit under the $3,000 rule.

Exception to $3,000 rule. When the tax you owe triggers the $3,000 rule, you can make the deposit by the 15th day of the next month, instead of within 3 banking days, if:

1) It is the first time you were required to make a deposit under the $3,000 rule within the previous 4 calendar quarters and earlier months of the current calendar quarter, and
2) The deposit is less than $10,000.

How to make deposits. Make your deposit by mailing or delivering a single check or postal money order covering both social security and withheld income taxes to an authorized financial institution or a Federal Reserve bank. The federal unemployment tax, explained later, must be paid separately. To help ensure proper crediting to your account when depositing taxes, write your employer identification number, the tax return number, and the tax period the deposit applies to on your check or money order. You can get the names of authorized institutions from a Federal Reserve bank. Each deposit must be accompanied by a federal tax deposit (FTD) coupon. It is very important to clearly mark the correct type of tax and tax period on each deposit coupon. This information is used by the IRS to credit your account.

A *Federal Tax Deposit Coupon Book* containing a supply of Form 8109, *Federal Tax Deposit Coupon,* and instructions will automatically be sent to you after you apply for an employer identification number. If you do not receive a book of coupons, contact your local IRS office. If you need more coupons, order them using the reorder form, Form 8109A, in the front of the coupon book. Be sure to show your name, employer identification number, and address on the reorder form. If you need to change your address, mark an "X" in the box for an address change and show the address where you want the coupon book sent on the reorder form. This will not change your address for the mailing of returns, refunds, or notices.

It takes about 5 or 6 weeks for delivery of the coupons. Allow ample time to reorder before using up your current supply. If you have a deposit due and there is not enough time to obtain a coupon book, blank forms (Form 8109–B, *Federal Tax Deposit Coupon)* are available at IRS offices.

Note: Do not use a Federal Tax Deposit Coupon to deposit delinquent taxes you have been assessed by the IRS. These payments should be mailed to the IRS Service Center that assessed the taxes together with copies of any related notices.

If you have not received your employer identification number and must make a deposit, mail your payment with an explanation to the IRS service center where you file your return. Make your check payable to IRS and show on it your name, address, kind of tax, period covered, and the date you applied for your employer identification number.

Timeliness of deposits. The timeliness of a deposit depends on the date the authorized financial institution or Federal Reserve bank receives it. A deposit received after the due date will be considered timely if you can establish that it was mailed at least two days before the due date. However, deposits of $20,000 or more by an employer required to deposit tax more than once a month must be received by the due date to be timely.

Penalties. If you do not deposit social security and withheld income taxes on time with an authorized financial institution or a Federal Reserve bank, you may have to pay a penalty. In addition, the IRS can require you to file monthly returns for these taxes on Form 941M.

If you withhold income and social security taxes from employees and do not pay the taxes to IRS or deposit them, you may be subject to a penalty of 100% of the tax. If you are the person responsible for the collection and payment of withholding taxes, you can be subject to this penalty even if you are an officer or employee of a corporation or a member or employee of a partnership.

Federal tax deposit penalties. Beginning in 1990, the penalty for a late tax deposit is based on the length of time the deposit is late. The following penalties now apply for late deposits.

1) If the deposit is not more than 5 days late, the penalty is 2% of the underpayment.
2) If the deposit is more than 5 days late but not more than 15 days late, the penalty is 5% of the underpayment.
3) If the deposit is more than 15 days late, the penalty is 10% of the underpayment.
4) If the deposit is not made within 10 days after IRS issues the first notice demanding payment or by the day that notice and demand for immediate payment is given, the penalty is 15% of the underpayment.

Forms for Employees

Form W–2. You must furnish copies of Form W–2 to each employee from whom income or social security taxes have been withheld. You must also furnish it to employees from whom income tax would have been withheld if the employee had claimed no more than one withholding allowance. The Form W–2 must show the total wages and other compensation paid (whether or not they are subject to withholding), the amounts deducted for income and social security taxes including the hospital insurance portion, and total advance earned income credit payments. Fill in all the information required on the statement. More detailed information for preparing Form W–2 is contained in the *Instructions for Forms W–2 and W–2P.*

Form W–2 is a six-part combined federal-state form designed for use by employers in states where only federal tax must be withheld and in states where both federal and state taxes must be withheld. This form may also be used where city or other subdivision taxes are withheld. It is printed in sets of six copies so that copies are available for filing and for the employees' records.

Furnish copies of Form W–2 to employees as soon as possible after December 31 so they may file their income tax returns early. In any event, you must furnish the employee Form W–2 or its equivalent no later than January 31. However, when an employee who leaves your employment gives you a written request for the form earlier, you must give it to him or her within 30 days after you receive the request if the 30–day period ends before January 31. You should keep any undeliverable employee copies of Form W–2 for at least 4 years after the date the tax for the return period to which they relate becomes due or is paid, whichever is later.

Form W–2P. Use this form to report periodic retirement plan distributions (for example, retired or retainer pay, annuities, or pensions) as well as annuities paid under commercial, individually purchased contracts.

Note. For 1991, Form W–2P will be merged into Form 1099–R. The combined form will be filed with IRS and will be titled Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.*

Form W–3. Employers must file Form W–3 annually to transmit Forms W–2 and W–2P to the Social Security Administration in accordance with the instructions for Form W–3. These forms will be processed by the Social Security Administration which will then furnish the IRS with the income tax data that it needs from the forms. You must file 1990 Forms W–2 and W–2P on magnetic media if you file 250 or more forms. The 250 requirement applies separately to each form.

Form W–3 and its attachments must be filed separately from the Forms 941 by the last day of February following the calendar year for which the Forms W–2 and W–2P are prepared.

Extensions. If you are unable to file Forms W–2 and W–2P with IRS on either paper forms or magnetic media by the due date, get new Form 8809, *Request for Extension of Time To File Information Returns.* You must, however, furnish the required statements to recipients by the due date.

Reconciliation of Forms 941 and W–3. Amounts reported on the 4 quarterly Forms 941 must agree with the totals reported on Form W–3. The amounts that must agree are: income tax withheld, social security wages, social security tips, and the advance earned income credit.

Correcting Forms 941 and W–2. Use Form 941c, *Statement to Correct Information,* to correct income and social security tax information reported on Form 941 (or Forms 941E, 942, or 943). Attach Form 941c to the tax return making the adjustment. Social security tax information can be corrected for prior years, but income tax information can only be corrected for earlier periods of the current calendar year.

Since Form W–2 is used by the Social Security Administration (SSA) to post the employee's social security wages and tips to his or her earnings record, you must file a Form W–2c, *Statement of Corrected Income and Tax Amounts,* with SSA and give copies to the employee for any social security correction made after you have filed Form W–2 (or Form W–2P) with SSA. Send Form W–2c to SSA with Form W–3c, *Transmittal of Corrected Income and Tax Statements.* If you are sending only one form or the forms are only correcting the employees' names and social security numbers, Form W–3c is not needed.

Federal Unemployment Tax

The federal unemployment tax system, along with the state systems, provides unemployment payments to workers who have lost their jobs. Most employers pay both a state and the federal unemployment tax. However, even if you are exempt from state tax, you may still have to pay the federal tax.

Use the following three tests to determine whether you must pay federal unemployment (FUTA) tax. Each test applies to a different category of employee, and each is independent of the others. It is possible to be liable for the tax in one category, but not in another. If a test describes your situation either during the current calendar year or during the preceding calendar year, you are subject to FUTA tax on the wages you pay to employees in that category during the current calendar year.

1) In general. You are subject to federal unemployment tax on the wages you pay employees who are not farm workers or household workers if:
   a) In any calendar quarter, the wages you paid to employees in this category totaled $1,500 or more, or
   b) In each of 20 different calendar weeks, there was at least a part of a day in which you had an employee in this category. The 20 weeks do not have to be consecutive. Nor does it have to be the same employee each week. Individuals on sick leave or vacation are counted as employees.
2) Household workers. You are subject to federal unemployment tax on the wages you pay to household workers, if the cash wages you paid to employees in this category totaled $1,000 or more in any calendar quarter. A household worker is an employee who performs domestic services in a private home, local college club, or local college fraternity or sorority chapter. In figuring the $1,000 minimum, do not count the value of meals or lodging you provide your employees. Count only the wages you pay in money.
3) Farm workers. You are subject to federal unemployment tax on the wages you pay to farm workers if:
   a) In any calendar quarter, the cash wages you paid for farm labor totaled $20,000 or more, or
   b) In each of 20 different calendar weeks, there was at least one day in which you had 10 or more farm worker employees. The 20 weeks do not have to be consecutive. Nor does it have to be the same 10 employees each week. Nor do all 10 employees have to work a full day or the same part of the day. Individuals on sick leave or vacation are counted as employees.

Tips. Tip income (including credit card tips) reported by the employee to the employer for social security tax purposes is considered wages for federal unemployment tax purposes.

Wages not paid in money. If in the course of your trade or business you pay your employees in some medium that is neither cash nor a readily negotiable instrument (such as a check), you are said to pay them "in kind." Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, wages paid in kind are treated as wages paid in money. The value of a wage payment in kind is the fair market price it would have on the day it is made. For the treatment of ***meals and lodging,*** see the discussion under *Social Security Taxes* in Publication 937.

Payments in kind for farm labor are not considered wages. Do not count them either to figure whether you are subject to federal unemployment tax under test (3) above, or to figure how much tax you owe. Nor count payments in kind to household workers when figuring whether you are subject to federal unemployment tax under test (2) above.

Wages of foreign workers. Federal unemployment tax does not apply to the wages of a worker admitted to the United States under contract to perform farm labor for you before 1993 and who returns to his or her own country when the contract is completed. However, count the wages you pay to an alien worker in figuring whether you are subject to federal unemployment tax for your other farm workers under rule (3) above.

Other exceptions. Not all payments you make to your employees are considered wages for federal unemployment tax purposes. For example, payments made under the workers' compensation law are not counted as wages.

Nor does the tax apply to certain types of employment. For example, if you hire cooperative education students, you are not subject to FUTA tax on their wages.

Additional information. See Circular E (Circular A for farm labor) for a list of payments excluded from federal unemployment wages and a list of the types of employment not subject to the tax.

Figuring the Tax

The federal unemployment tax is figured on the first $7,000 in wages paid to each employee during 1990. This $7,000 maximum is scheduled to remain the same for 1991. The tax is imposed on you as the employer. You must not collect it or deduct it from the wages of your employees.

Example. In November 1989, you hire Al Green and pay him $3,500 in wages before the year ends. All $3,500 is subject to the federal unemployment tax. The first $7,000 you pay him in 1990 is also subject to the tax. Al's total wages for 1990 reach the $7,000 mark in mid-March. None of the wages you pay him after that in 1990 is subject to the tax.

Then, in July, Al quits his job, and you hire someone to replace him. The first $7,000 you pay his replacement in 1990 is also subject to the tax.

Tax rate and credit. The gross federal unemployment tax rate for 1990 is 6.2%. (The rate is scheduled to remain the same for 1991.) However, you are given a credit of up to 5.4% for the state unemployment tax you pay. The net tax rate, therefore, can be as low as 0.8% (6.2% – 5.4%) if your state is not subject to a credit reduction. If your state tax rate (experience rate) happens to be less than 5.4%, you are still allowed the full 5.4% credit. But you cannot take the credit for any state taxes you fail to pay. If for any reason you are exempt from state unemployment tax, the full 6.2% rate applies.

Credit reduction. The 5.4% credit may be reduced for employers in some states. A credit reduction is required if a state's unemployment fund borrows from the federal government and keeps an outstanding balance for two or more years. No state is subject to a credit reduction for 1990.

Successor employer. If you take over the business of an employer who was subject to the federal unemployment tax, you may, in figuring the $7,000 limit, count wages paid by that employer to employees who continue to work for you.

Concurrent employment by related corporations. If two or more related corporations employ the same individual at the same time and pay this individual through only one of the corporations (the "common paymaster"), the corporations are considered a single employer. They have to pay, in total, no more in federal unemployment taxes than a single employer would pay.

Each corporation must pay its own share of employment taxes and may deduct only its own share of the wages paid.

To take the deduction, the corporation must reimburse the common paymaster for its share of wages and tax payments. The common paymaster cannot deduct wage and tax payments for employee services performed for another corporation in the related group.

Reporting and Paying the Tax

The federal unemployment tax is reported on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return.* This form covers one calendar year and is generally due one month after the year ends. However, you may have to make deposits of the tax before filing the return.

Form 940–EZ. Form 940–EZ, a simplified version of Form 940, can be used by small employers: (1) who paid unemployment taxes to only one state; (2) who paid the state taxes by the due date of Form 940–EZ; and (3) whose wages taxable for FUTA tax were also taxable for state unemployment tax.

Deposit due dates. If at the end of any calendar quarter, you owe, but have not yet deposited, more than $100 in federal unemployment (FUTA) tax for the year, you must make a deposit by the end of the next month. The due dates are shown in the following chart:

If your undeposited FUTA tax is more than $100 on:	Deposit the full amount by:
March 31	April 30
June 30	July 31
September 30	October 31
December 31	January 31

If the tax is $100 or less at the end of a quarter, you do not have to deposit it. But you must add it to the tax for the next quarter. Then, in the next quarter, if the total undeposited tax is more than $100, a deposit will be required.

Weekends and holidays. If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next date that is not a Saturday, Sunday, or legal holiday. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

Additional liability because of credit reduction. No state is subject to a credit reduction for 1990. However, if the 5.4% credit for 1991 is reduced for you and other employers in your state, it creates an additional 4th quarter liability. Before the 4th quarter, you are not liable for depositing any tax owed because of a credit reduction. The credit reduction becomes final on November 10 each year. To figure the amount of federal unemployment tax you owe for the 4th quarter of 1991 if you are subject to a credit reduction, follow these steps:

1) First, using an effective tax rate of 0.8% for 1991, figure the tax you owe on wages paid during the 4th quarter.
2) Next, multiply the total wages subject to federal unemployment tax in all 4 quarters by the amount of the credit reduction.
3) Add together the amounts from these two steps. The result is the federal unemployment tax you owe for the fourth quarter.

Figuring deposits for 1991. To figure whether you must make a deposit for 1991, assume that you will be able to take the full credit of 5.4%. That is, use an effective tax rate of 0.8% (6.2% – 5.4%). Next, figure the part of the wages you paid during the quarter that is subject to the tax. Multiply that amount by 0.8% (.008). The result is the amount of federal unemployment tax you owe for the quarter.

Making deposits. The rules for depositing FUTA tax are the same as those discussed earlier for depositing social security and withheld income taxes. See *How to make deposits,* earlier.

Filing the return. Form 940 is due one month after the end of the calendar year—by January 31. However, if you deposit the tax on time and in full, you have an extra 10 days to file—until February 10.

Records. You must keep all records pertinent to the preceding taxes available for inspection by officers of the IRS. See *Records of Employers* in Chapter 2 for specific records that you must maintain.

Additional information. More information on the federal unemployment tax can be found in the instructions to Form 940.

Advance Payment of Earned Income Credit

You must pay the earned income credit in advance to eligible employees who have filed a Form W–5, *Earned Income Credit Advance Payment Certificate,* with you. This allows those employees to receive the benefit of their credit each payday rather than having a single amount credited to them later on their tax return.

The payment is added to the pay of the employees each payday. It is figured from tables in Circular E, *Employer's Tax Guide.* Employers reduce their liability for income tax withholding and social security taxes by the total amount of the advance earned income credit payments made. For more information, see *Advance Payment of Earned Income Credit* in Publication 937.

Earned income credit notification. You must notify each employee who worked for you at any time during the year and from whom you did not withhold any income tax about the earned income credit (EIC). However, you do not have to notify employees who claim exemption from withholding on Form W–4, *Employee's Withholding Allowance Certificate.*

You can meet the notification requirement by giving each employee the official IRS Form W–2 which contains the notification on the back of Copy C, or you can give each employee Notice 797, *Notice of Possible Federal Tax Refund Due to the Earned Income Credit (EIC).* You can also use your own written statement as long as it has the exact wording of Notice 797, or you can furnish substitute Forms W–2, *Wage and Tax Statement,* containing the exact wording shown on the back of Copy C of the official Form W–2. You must so notify each employee, either in person or by first class mail, with his or her 1990 Form W–2 or within one week before or after that time, unless you use a substitute Form W–2 as the notice. If you do not furnish Form W–2 on time, you must notify the employee about the EIC by the date Form W–2 was required to be furnished. If Form W–2 is not required, you must notify the employee about the EIC by February 7, 1991.

You can request supplies of Notice 797 by calling the IRS toll-free telephone number 1–800–TAX–FORM (1–800–829–3676).

34. Alternative Minimum Tax

Important Changes for 1990

Alternative minimum tax. For tax years beginning after 1989, the following changes have been made to the minimum tax rules.

The ***alternative depreciation system*** is used for property placed in service after 1989. This requires use of the straight-line method over a recovery period.

Intangible drilling costs are capitalized and amortized over a 60–month period beginning with the month the costs were paid or incurred.

Depletion is computed using the cost depletion method for property placed in service after 1989.

The ***credit*** allowed against regular tax for alternative minimum tax on deferral and exclusion items paid in previous years is increased by any credit not allowed by the limit for orphan drugs or nonconventional fuels.

The ***limit on foreign tax credit*** does not apply to certain corporations.

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. So that taxpayers (including corporations) who benefit from these laws will pay at least a minimum amount of tax, a special tax has been enacted—the "alternative minimum tax" for corporations and individuals.

The rules discussed in this chapter apply to corporations. The alternative minimum tax that applies to individuals is discussed in Publication 909, *Alternative Minimum Tax for Individuals.*

A partnership does not itself pay minimum tax. However, each member of a partnerhip must take into account his or her distributive share of the partnership's tax preference items and adjustments.

An alternative minimum tax for corporations, similar to the alternative minimum tax for individuals, replaces the minimum tax under prior law. The rate is 20%, and there is a $40,000 exemption amount that is reduced (but not below zero) by 25% of the amount by which alternative minimum taxable income exceeds $150,000.

A minimum tax credit is allowed against your regular tax liability in subsequent years for the alternative minimum tax that is attributable to certain preferences and adjustments. You must consider your alternative minimum tax when determining your 1991 estimated tax.

Figure the alternative minimum tax as follows:

Begin with ***taxable income before net operating loss deduction*** on the return (line 28 minus line 29b on Form 1120, and line 24 minus line 25b on Form 1120–A).

Add or Subtract
Adjustments to taxable income
Add
Tax preferences
Equals
Alternative minimum taxable income
Subtract
Exemption amount
Multiply by
20%
Subtract
Foreign tax credit
Equals
Tentative minimum tax
Subtract
Regular tax
Equals
Alternative minimum tax.

Form 4626. Use Form 4626, *Alternative Minimum Tax—Corporations*, to figure the corporation's alternative minimum tax. This form must be filed if the corporation's taxable income plus adjustments and tax preference items totals more than $40,000. This form may also be used to figure the corporation's environmental tax, discussed in Chapter 29.

Alternative Minimum Taxable Income

To figure the alternative minimum tax, you must first arrive at alternative minimum taxable income. Begin with taxable income before the net operating loss deduction shown on the tax return (line 28 minus line 29b on Form 1120; and line 24 minus line 25b on Form 1120–A). Combine that with the adjustments discussed next, and the preference items discussed later.

If there is a net operating loss deduction, figure a separate limit on the amount that can be claimed. There is also separate computation, if applicable, for the adjusted net book income of the corporation.

Note: If a corporation's tax base is measured by something other than taxable income, such as real estate investment trust taxable income or life insurance company taxable income, alternative minimum taxable income is determined using that tax base.

Adjustments to Taxable Income

To figure the alternative minimum taxable income, certain adjustments must be made to the taxable income shown on the return. These adjustments are designed to eliminate the tax advantages of items that receive preferential tax treatment. The amount of the adjustment is generally the difference between the recomputed item and the amount shown on the return. They can be either increases or decreases.

Accelerated Depreciation

For property placed in service before 1987, accelerated depreciation was a tax preference item. Continue to treat depreciation on that property as a preference item. See *Accelerated Depreciation on Real Property Placed in Service Before 1987*, and *Accelerated Depreciation on Leased Personal Property Placed in Service Before 1987*, discussed later under *Tax Preference Items*.

Depreciation of property placed in service after 1986. The depreciation deduction used in computing alternative minimum taxable income is the amount calculated under the alternate modified accelerated cost recovery system (MACRS). For real property, use the straight-line method with a 40-year recovery period and the mid-month convention. For most property other than real property, use the 150% declining balance method switching to the straight-line method when it results in a larger allowance. The adjustment applies to real and personal property placed in service after 1986, other than transition property. It also applies to property placed in service after July 31, 1986, and before 1987 if you elected the MACRS.

The following types of property are not considered in figuring this adjustment item:

Property you elect to exclude from MACRS that is depreciated under the unit-of-production method or most other methods of depreciation not expressed in terms of years,

Certain public utility property,

Any motion picture film or video tape, or

Any sound recording.

The adjustment is the difference between the total depreciation for all property for alternative minimum tax purposes and the total depreciation for regular income tax purposes.

The effect of using two different types of depreciation (one for regular income tax and one for alternative minimum tax) is that a corporation will have a different basis in the property for alternative minimum tax. This means, for example, that if a corporation sells the property, the gain will be different for alternative minimum tax purposes. See the later discussion of *Basis Adjustment*.

For more information on depreciation, see Chapter 12.

Circulation Costs

This adjustment is for personal holding companies only. In figuring alternative minimum taxable income, circulation costs must be amortized over 3 years beginning with the tax year in which the expenditures were made. The adjustment is the difference between the amount deducted for regular tax purposes and the refigured amortization.

Mining Exploration and Development Costs

This deduction is computed by taking the amount you are allowed as a deduction for regular tax purposes for mining exploration and development costs and amortizing it ratably over a 10-year period. The adjustment is the difference between the deduction claimed for regular tax and the deduction allowed for alternative minimum tax.

If a loss is sustained for mining property (that is, the mine is abandoned as worthless), in figuring alternative minimum taxable income, you can deduct all mining exploration and development costs relating to the property that have not yet been written off.

Long-Term Contracts

In the case of any long-term contract you enter into after February 28, 1986, the completed contract method of accounting, or certain other methods of accounting for long-term contracts, are not allowable. Instead, you are required to apply the percentage of completion method (as modified by the rules for long-term contracts under section 460 of the Internal Revenue Code) in determining alternative minimum taxable income relating to that contract.

The adjustment is the difference between income determined using the method of accounting used for regular tax purposes and income determined using the percentage of completion method of accounting, plus any other applicable adjustment. If the refigured taxable income is less, show the adjustment as a negative amount.

Home construction contracts. The rules for long term contracts do not apply to:

1) Any ***home construction contract*** you entered into after after June 20, 1988, with respect to which you meet the ***small home construction contract*** requirements (see section 460(e) of the Internal Revenue Code), or
2) Any home construction contract you entered into in a tax year beginning after September 30, 1990, regardless of whether you meet the small home construction contract requirements.

For a contract described in (1) the percentage of the contract completed is to be determined using the simplified procedures for allocating costs (see IRC section 460(b)(4)).

Amortization of Certified Pollution Control Facilities

For purposes of the alternative minimum tax, your amortization deduction for a certified pollution control facility placed in service after 1986 is determined under the alternate MACRS rule (see Chapter 12). Also see *Amortization of Certified Pollution Control Facilities (Before 1987)*, discussed later under *Tax Preference Items*.

Installment Sales of Certain Property

In the case of any disposition of inventory or stock in trade, the installment method of accounting does not apply for purposes of the alternative minimum tax. Therefore, a corporation is required to recognize all gain realized on the disposition in the year of sale. The adjustment is the difference between the recognition of all gain in the year of disposition and the amount of gain recognized under the installment method of accounting. For years in which the sale proceeds are actually collected, the regular taxable income must be decreased to arrive at the alternative minimum taxable income.

Repeal. The installment method of accounting is repealed (for regular tax purposes) for dealer dispositions occurring after 1987. However, for regular tax purposes, a dealer disposition does not include:

1) The disposition of property used or produced in the trade or business of farming, or
2) Certain dispositions of timeshares or residential lots for which you elected to pay interest.

Item (2) applies for alternative minimum tax purposes only. Therefore, no adjustments are normally necessary for dealer dispositions occurring after 1987, although they are still possible.

Basis Adjustment

If a corporation sold property during the year, you must refigure the gain or loss from the sale using the corporation's adjusted basis for alternative minimum tax purposes. The following alternative minimum tax adjustments will require changes to the corporation's regular tax basis:

Depreciation,
Circulation expenses,
Mining exploration and development costs, and
Pollution control facilities.

Enter on line 2e of Form 4626, the difference between the gain (or loss) reported on the corporation's return for regular tax purposes and the recomputed gain (or loss) for alternative minimum tax purposes.

Certain Loss Limitations

You must take into account the corporation's alternative minimum tax adjustments and preferences before you apply certain loss deferral rules.

The loss deferral rules include limits on losses due to:

A partner's basis in the partnership interest, and
The at-risk limits.

The adjustment is the difference between the allowable loss reported for regular tax purposes and the corporation's recomputed allowable loss. This figure could be negative if the recomputed allowable loss is more than the allowable loss reported for regular tax purposes.

Tax Shelter Farm Loss

This adjustment applies to personal service corporations only. In figuring alternative minimum taxable income, no loss from a tax shelter farm activity is allowed. Generally, a tax shelter farm activity is any farming syndicate or other passive farm activity. The loss from a tax shelter farm activity is allowed in figuring alternative minimum taxable income for later years as a deduction against income from the activity or for the year you dispose of the corporation's entire interest in the activity.

The amount of the loss that is disallowed is reduced by the amount by which a corporation is insolvent as of the end of the tax year. A corporation is insolvent to the extent that its liabilities exceed the fair market value of its assets.

Passive Activity Loss

This adjustment applies to closely held and personal service corporations only. To determine the adjustment for a passive activity loss, refigure the loss taking into account the corporation's alternative minimum tax adjustments and preferences. Use a separate Form 8582, *Passive Activity Loss Limitations*, to refigure the loss. The passive activity phase-in rules do not apply for alternative minimum tax purposes. The adjustment is the difference between the allowable loss reported for regular tax and the refigured allowable loss.

The amount of the loss that is disallowed is reduced by the amount by which a corporation is insolvent as of the end of the tax year. A corporation is insolvent to the extent that its liabilities exceed the fair market value of its assets.

Capital Construction Funds of Shipping Companies

Deposits into a capital construction fund established under section 607 of the Merchant Marine Act of 1936 are not deductible, and its earnings (including gains and losses) on amounts in the fund are not excludable, in determining alternative minimum taxable income. No reduction in basis, required by section 607(g) of the Merchant Marine Act of 1936 should be made for amounts withdrawn from the fund if the amounts have previously been included in alternative minimum taxable income.

Alternative Tax Net Operating Loss Deduction

You must figure the corporation's alternative tax net operating loss deduction. The rules covering years after 1986 are discussed first. For the rules covering carryover of pre-1987 net operating losses, see *Carrybacks and carryovers*, later.

Figuring alternative tax net operating losses after 1986. For alternative minimum tax purposes, figure a net operating loss for a tax year beginning after 1986 in generally the same manner as for regular tax, except:

- Make the alternative minimum tax adjustments (discussed earlier) to the net operating loss that you figured for regular tax purposes, and
- Reduce the net operating loss by the tax preference items for such year (discussed later) except for charitable contributions of appreciated property to the extent the tax preference item increased the net operating loss for the tax year.

Carrybacks and carryovers. After making the above calculations, the amount of the net operating loss that you may deduct in a carryback or a carryover year may not exceed 90% of the corporation's alternative minimum taxable income for that year, as figured before the net operating loss deduction.

You may carry back the net operating loss 3 years or carry it forward 15 years. This is the same as under the regular NOL rules. However, if you elect not to use the carryback of an NOL for regular tax purposes, you may ***not*** carry it back for alternative minimum tax purposes.

In years that a corporation does not have an alternative minimum tax liability, you must still limit the net operating loss deduction to 90% of the corporation's "alternative minimum taxable income" for that year. Use Form 4626 to figure alternative minimum taxable income even though the corporation does not have an alternative minimum tax liability.

Figuring the amount of pre-1987 carryovers. The amount of a net operating loss carryforward from tax years beginning before 1987 that you may carry to tax years beginning after 1986 is the amount of your regular net operating loss carryover. An adjustment is required if the corporation had a deferred add-on minimum tax liability for a year before 1987.

Adjusted Current Earnings (ACE)

For tax years beginning after 1989, corporations must increase their alternative minimum taxable income (AMTI) by the adjustment for ACE. This adjustment is equal to 75% of the excess, if any, of the corporation's ACE for the tax year over the corporation's pre-adjustment AMTI. Pre-adjustment AMTI is the corporation's AMTI for the tax year determined without the adjustment for ACE and without the alternative tax net operating loss deduction. A negative adjustment is allowed for 75% of any excess pre-adjustment AMTI over ACE to the extent of the net positive adjustments for ACE in prior tax years.

ACE is the corporation's pre-adjustment AMTI for the tax year determined by taking into account certain specified adjustments. Some of these adjustments are discussed next.

- The ***alternative MACRS depreciation system*** is used for property placed in service after 1989. This system requires use of the straight-line method over a recovery period.
- ***Intangible drilling costs*** are capitalized and amortized over a 60–month period beginning with the month the costs were paid or incurred.
- ***Depletion*** is computed using the cost depletion method for property placed in service after 1989.
- ***Circulation*** and ***organizational*** expenses are not amortizable.
- ***Installment sales*** are figured without the use of the installment method.

See the instructions to Line 5, Form 4626, for more information on the ACE computation.

Tax Preference Items

Tax preference items are other income items and deductions that receive special treatment under the tax laws. They must be added back to the taxable income shown on your return in figuring a corporation's alternative minimum taxable income.

Accelerated Depreciation on Real Property Placed in Service Before 1987

This tax preference item is the depreciation or amortization a corporation took during the year on real property placed in service before 1987, minus the depreciation the corporation would have been allowed under the straight-line method. Figure this amount separately for each separate item of property. Generally, each building (or its component) is a separate item of property. Do not figure this tax preference for an item of property in the year that you dispose of it.

For property a corporation depreciates as 15–year real property under the accelerated cost recovery system (ACRS), figure straight-line depreciation using a recovery period of 15 years and no salvage value. However, if the actual recovery period is longer than 15 years, you will not have a tax preference item.

For property depreciated as 18–year real property under ACRS, figure straight-line depreciation using a recovery period of 18 years and no salvage value. For property that a corporation is depreciating as 19–year real property under ACRS, figure straight-line depreciation using a recovery period of 19 years and no salvage value.

For property a corporation placed in service between August 1, 1986, and December 31, 1986, and chose to depreciate under the modified accelerated cost recovery system (MACRS), generally figure straight-line depreciation using a recovery period of 40 years. The modified accelerated cost recovery system is explained in Chapter 12.

For property depreciated under another method, figure straight-line depreciation using the same basis, useful life, and salvage value that was first used to depreciate the property. If the corporation did not use a useful life or salvage value, the useful life or salvage value for straight-line depreciation is the one that would have been proper if it had actually taken depreciation under the straight-line method.

If a corporation amortizes rehabilitation expenses for low-income rental housing or a certified historic structure, the way you figure straight-line depreciation depends on whether you would have otherwise depreciated the corporation's rehabilitation expenses under ACRS. If the rehabilitated property would have qualified for ACRS, use a 15–year recovery period to figure straight-line depreciation. If the property would not have qualified for ACRS, figure the straight-line depreciation that would have been allowed had the corporation not claimed rapid amortization.

Accelerated Depreciation on Leased Personal Property Placed in Service Before 1987

This tax preference item is the depreciation or amortization a corporation took during the tax year on personal property it leased to others minus the depreciation or amortization it would have been allowed to take if it used the straight-line method.

This is a tax preference item only if the corporation is a personal holding company.

Placed in service between August 1, 1986, and December 31, 1986. For leased personal property a corporation elects to depreciate under MACRS, figure the depreciation under the 150% declining balance method (switching to the straight-line method when it results in a larger allowance.)

Amortization of Certified Pollution Control Facilities (Before 1987)

A corporation's amortization deduction for a certified pollution control facility placed in service before 1987, minus the depreciation deduction that would normally be allowed, is a tax preference item. However, it is not a tax preference for the year in which the corporation disposes of the facility.

Note: The depreciation normally allowed may be more than straight-line depreciation and thus itself may result in an item of tax preference explained under *Accelerated Depreciation on Real Property Placed in Service Before 1987*, above. However, to the extent that the amortization deduction is treated as a preference item under this paragraph, it is not an item of tax preference under the above item.

Placed in service after 1984. To figure its amortization deduction for a pollution control facility placed in service after 1984, a corporation must reduce its basis in the facility by 20%. Then, to figure its tax preference item for this deduction, it takes 59⅚% of the difference between the amortization deduction (figured using this reduced basis) and the depreciation deduction that would otherwise be allowed.

Example. The Feather Corporation placed a certified pollution control facility in service on January 1, 1986, at a cost of $1,000,000 and chose to amortize the facility over 60 months. When figuring the amortization, the basis of the facility was reduced by $200,000 (20% of $1,000,000). Feather's deduction for amortization in 1986, 1987, 1988, and 1989 was $160,000 ($800,000 × 12 months/60 months). The same amount of $160,000 is deducted in 1990. The facility is 19–year real property and was placed in service at the beginning of Feather's 1986 tax year. The depreciation deduction that would have been allowed under ACRS for 1990 is 6.3% of $1,000,000, or $63,000. The excess amortization is $97,000 ($160,000 minus $63,000), and the amount treated as a tax preference is $58,038 (59⅚% of $97,000).

Placed in service after 1982 and before 1985. To figure the tax preference item for a pollution control facility placed in service after 1982 but before 1985, follow the steps under *Placed in service after 1984*, substituting 15% for 20% and 71.6% for 59⅚%.

Percentage Depletion

If a corporation's depletion deduction for the year is more than its adjusted basis in the property at the end of the year (figured before reducing basis by the depletion deduction), the difference is a tax preference item. This preference item should be figured separately for each separate piece of property being depleted.

Depletion of coal and iron ore. A corporation (other than an S corporation) figures its tax preference for the depletion of coal (including lignite) and iron ore as follows:

1) Subtract the corporation's basis in the property at the end of the year (before adjusting it for the year's depletion) from the year's percentage depletion on the property.
2) Reduce the corporation's percentage depletion by 20% of the amount figured in (1). This is the most the corporation can deduct for percentage depletion on the property.
3) Subtract the corporation's basis in the property (before adjusting it for the year's depletion) from the amount figured in (2). The result is the corporation's tax preference item for percentage depletion.

Intangible Drilling Costs (IDCs)

If you have elected the optional 60–month write-off for IDCs, these costs are not a tax preference item. In general, this tax preference item is the amount by which excess IDCs paid or incurred during the year on a corporation's oil, gas, and geothermal properties are ***more than 65%*** of the net income of these properties.

Excess IDCs. Those are costs incurred or paid in connection with oil, gas, and geothermal wells over the amount that would have been allowed if the costs had been amortized using a 10–year straight-line method or any permitted cost depletion method.

Net income from oil, gas, and geothermal properties for this purpose is the gross income from all these properties over the deductions allocated to these properties. Deductions do not include excess IDCs or costs related to nonproductive wells.

Bad Debt Deductions—Financial Institutions

The deduction allowed for a reasonable addition to a financial institution's reserve for bad debts, minus the amount that would have been allowed based on actual loss experience is a tax preference item.

A financial institution must reduce its bad debt deduction by 20%. It figures its tax preference item by subtracting its actual bad debt losses for the year from this reduced bad debt deduction.

Tax-Exempt Interest on Specified Private Activity Bonds

This tax preference item is the tax-exempt interest on private activity bonds generally issued after August 7, 1986 (or, on or after September 1, 1986, in the case of bonds satisfying pre-Tax Reform Act of 1986 definitions of governmental bonds), reduced by expenses not allowed in computing the regular tax because they are related to tax-exempt income that would have been allowable if the obligations were not exempt.

For purposes of this tax preference item, a private activity bond does not include a qualified section 501(c)(3) bond, or any refunding bond (whether a current or advance refunding) if the refunded bond (or in case of a series of refundings, the original bond) was issued before August 8, 1986. Any exempt-interest dividends a corporation receives from a mutual fund must be separated from the total and included in this preference item. In addition, any exempt-interest dividend will be treated as interest on a specified private activity bond to the extent of its proportionate share of the interest on such bonds received by the company paying the dividend.

Charitable Contributions of Appreciated Property

If you make a charitable contribution of appreciated capital gain property, an amount equal to the portion of the regular tax deduction claimed that exceeds the property's adjusted basis is treated as a tax preference item. For purposes of alternative minimum tax, capital gain property has the same meaning as under the rules relating to charitable deductions.

Optional Write-Off

A corporation may choose an optional 3–year or 10–year write-off of certain adjustments and preference items in figuring its regular income tax. If it does, these items will not be considered adjustments or preference items for purposes of the alternative minimum tax. A corporation may make this choice for the following items.

3–year write-off. A corporation can choose to deduct, in equal installments over a 3-year period, the cost of increasing the circulation of a newspaper or periodical.

10–year write-off. The costs a corporation can choose to deduct in equal installments over 10 years are:

Mining exploration and development costs,
Development expenses, and
Research and experimental expenses.

Choosing the optional write-off. Choose the optional write-off by the due date (including extensions) of the corporation's income tax return for the year for which you are making the choice. Attach to the corporation's return a statement which includes:

The corporation's name, address, and employer identification number.

The specific write-off you are choosing.

A note you are making this choice under section 59(e) of the Internal Revenue Code.

The year for which you are making the choice and the tax preference item to which it applies.

You may use Form 4562, *Depreciation and Amortization,* to choose the optional write-off. Once the optional write-off is selected with respect to any qualified expense, the choice may be revoked only with the consent of the IRS.

Figuring Alternative Minimum Tax

After you arrive at alternative minimum taxable income, figure the tax. Subtract from the corporation's alternative minimum taxable income an ***exemption amount.*** Next multiply the balance by the alternative minimum tax rate of 20%. This will be the ***tentative minimum tax.*** Subtract the corporation's ***regular tax*** from the tentative minimum tax. The result is the corporation's alternative minimum tax.

Exemption Amount

The alternative minimum tax is not intended to apply to corporations in the lower tax brackets with small amounts of adjustments or preference items. This is accomplished by subtracting an exemption amount from the corporation's alternative minimum taxable income before figuring the tentative minimum tax. The exemption amount is phased out for corporations with high income.

The maximum amount of this exemption is $40,000. However, it is reduced by $0.25 for every $1 by which the alternative minimum taxable income exceeds $150,000. Thus, the exemption amount is completely phased out when the corporation's alternative minimum taxable income exceeds $310,000.

Tentative Minimum Tax

The tentative minimum tax is figured by multiplying the corporation's alternative minimum taxable income, minus the $40,000 exemption amount, by 20%. This is the tentative minimum tax unless the corporation has an alternative minimum tax foreign tax credit. If the corporation has a foreign tax credit, subtract it to arrive at the tentative minimum tax.

Foreign tax credits. A corporation's foreign tax credit is figured by first using taxable income, adjustments, and tax preference items from sources outside the United States, to arrive at alternative minimum taxable income from sources outside the United States. Then, using both this amount for taxable income from sources outside the United States and the corporation's alternative minimum taxable income for total taxable income, compute the foreign tax credit on Form 1118, *Computation of Foreign Tax Credit-Corporations.*

Limit. The alternative minimum tax foreign tax credit cannot be more than the amount on Form 4626, line 11, less 10% of the amount that would be on that line if Form 4626 were refigured using zero on line 7.

Regular Tax

After you figure the corporation's tentative minimum tax, subtract its regular tax to arrive at the alternative minimum tax. ***Regular tax*** is the corporation's income tax on Page 2, line 1, Part 1, Form 1120-A, or line 3, Schedule J, Form 1120, minus any foreign tax credit (line 4a, Schedule J, Form 1120) and the possessions tax credit (line 4b, Schedule J, Form 1120).

Credits. If a corporation pays alternative minimum tax, it will not obtain any tax benefit from certain nonrefundable credits (listed below) other than the foreign tax credit. If a corporation has adjustments or preference items but does not pay alternative minimum tax because of the exemption amount, it may or may not receive any benefit from these credits.

A corporation may only claim these credits to the extent that its regular tax liability exceeds its alternative minimum tax liability. It cannot claim these credits to the extent they reduce the corporation's regular tax liability below the amount of its tentative minimum tax. Any excess credit will be allowed as a carryback or carryover under the usual rules for that credit.

The nonrefundable credits include:

Credit for fuel from a nonconventional source,

Targeted jobs credit,

Alcohol fuels credit,

Research credit, and

Low-income housing credit.

Minimum Tax Credit

A corporation may be eligible to take a minimum tax credit against its regular income tax. If a corporation paid an alternative minimum tax in 1987, 1988, or 1989, because of adjustments or preference items that defer its tax liability rather than cause a permanent avoidance of the tax, the corporation's 1987, 1988, or 1989 alternative minimum tax is available to be claimed as a credit against its regular income tax for 1990 and later years.

The credit is limited to the corporation's regular tax for the year to which it is carried less the following:

1) Foreign tax credit,
2) General business credit, and
3) The tentative minimum tax for the year in which the credit is being used.

The credit the corporation is allowed to take in 1990 is based on its 1987, 1988, or 1989 net alternative minimum tax. This is the alternative minimum tax the corporation actually paid in 1987, 1988, or 1989. The alternative minimum tax may have to be adjusted. See the following discussion.

Figuring the Credit

A corporation's net minimum tax is the amount of the net minimum tax for the year increased by the credit not allowed:

1) For producing fuel from a nonconventional source due to the tentative minimum tax for the year, and
2) Clinical testing expenses for certain drugs for rare diseases or conditions due to the tentative minimum tax for the year.

Carryforward of Credit

A corporation may carry the alternative minimum tax credit forward (indefinitely) to reduce its regular tax liability in future years. If the corporation does not use all of the credit in 1990, the balance may be carried forward to 1991 and subsequent tax years. If the corporation's net alternative minimum tax in subsequent tax years results in getting an additional credit, that credit is added to any carryforward balance from earlier years.

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35. Excise Taxes

This chapter outlines certain excise taxes paid to the government and tells what forms are needed to report and pay these taxes. The following excise taxes are covered:

- Environmental taxes
- Air transportation taxes
- Communications taxes
- Fuel taxes
- Manufacturers taxes
- Tax on tractors, and certain chassis and bodies for trucks, trailers, and semitrailers
- Tax on policies issued by foreign insurers
- Tax on obligations not in registered form
- Ship passenger tax
- Highway use tax on trucks, truck tractors, and buses
- Alcoholic beverage taxes
- Tobacco product taxes
- Firearms taxes
- Wagering taxes

Excise Tax Forms

Excise taxes are reported on a variety of tax forms. The most commonly used forms are mentioned briefly here.

Form 720

Form 720, *Quarterly Federal Excise Tax Return,* is used to report most excise taxes. Some of these taxes are computed on a separate form that is filed as an attachment to Form 720. Form 720 is filed quarterly, but the taxes generally must be deposited before the return is due.

For details of each tax, get Publication 510, *Excise Taxes for 1991,* and the appropriate forms. Publication 378, *Fuel Tax Credits and Refunds,* provides information to users of fuel for nontaxable purposes who may be eligible for credit or refund of the fuel excise tax.

The taxes reported on Form 720 are grouped as follows:

1) Environmental taxes,
2) Communications and air transportation taxes,
3) Fuel taxes,
4) Manufacturers taxes,
5) Retail taxes,
6) Ship passenger taxes, and
7) Other excise taxes.

Environmental taxes. Environmental taxes are imposed on:

1) Domestic crude oil received at a United States refinery;
2) Imported crude oil and imported petroleum products when entered into the United

States for consumption, use, or warehousing by the importer;
3) Domestic and imported taxable chemicals when sold or used by their manufacturer or importer;
4) Imported taxable substances when sold or used by their importer, and
5) Ozone-depleting chemicals and imported products containing those chemicals when sold or used by the manufacturer, producer, or importer.

Environmental taxes are figured on Form 6627, *Environmental Taxes,* an attachment to Form 720.

Communications and air transportation taxes. A tax is imposed on users of the following:

1) Toll telephone service,
2) Teletypewriter exchange service,
3) Local telephone service,
4) Transportation of persons by air,
5) Transportation of property by air, and
6) International air travel facilities.

The person receiving the payment is required to collect the tax from the customer and to file the return.

Fuel taxes. Excise taxes are imposed on:

1) Gasoline, including gasohol,
2) Gasoline used in noncommercial aviation,
3) Diesel fuel,
4) Aviation fuel other than gasoline,
5) Special motor fuels,
6) Fuels used on certain inland waterways, and
7) Alcohol sold as but not used as fuel.

Generally, taxpayers (other than special motor fuels taxpayers) must be registered with their local district director before incurring fuel tax liability. Fuel taxes are computed on Form 8743, *Information on Fuel Inventories and Sales,* an attachment to Form 720.

Manufacturers taxes. Excise taxes are imposed on the sale or use by the importer or manufacturer of certain articles. Form 8807, *Computation of Certain Manufacturers and Retailers Excise Taxes,* is used to figure the manufacturers tax on:

1) Sport fishing equipment,
2) Electric outboard motors and certain sonar devices,
3) Bows and arrows,
4) Firearms, shells and cartridges, and
5) Pistols and revolvers.

Other manufacturers taxes are imposed on:

1) Highway-type tires,
2) Gas guzzler cars—attach Form 6197,
3) Certain vaccines, and
4) Coal.

Retail taxes. A tax is imposed on the first retail sale by the manufacturer or importer of tractors, and of certain chassis and bodies for trucks, trailers, and semitrailers. The tax is computed on Form 8807 and attached to Form 720.

Ship passenger tax. A tax of $3 per passenger is imposed on the provider of covered voyages by ship in two situtations. The first stiuation is voyages on commerical passenger vessels extending over one or more nights. A commerical passenger vessel is a vessel with stateroom or berth accommodations for more than 16 passengers. The second situation is voyages on commerical vessels by passengers engaging in gambling on the vessels in international waters. The tax is imposed once on each voyage when each passenger first embarks or disembarks in the United States. The tax is effective for voyages beginning after 1989.

Other excise taxes. A tax is imposed on insurance policies issued by foreign insurers. A tax is imposed on registration-required obligations that are not in registered form.

Excise Taxes Not Reported on Form 720

In addition to the taxes reported on Form 720, other excise taxes are reportable on other forms. These forms and taxes are:

1) Form 2290—Highway Use Tax,
2) ATF Form 5630.5—Alcohol, Tobacco, and Firearms, and
3) Forms 730 and 11–C—Wagering.

If any of these taxes appear to apply to you, see the following discussions for information about them.

Form 2290—Highway Use The federal excise tax on the use of certain trucks, truck tractors, and buses on U.S. highways is reported on Form 2290, *Heavy Vehicle Use Tax Return.* The tax applies to trucks having taxable gross vehicle weights of 55,000 pounds or more. Vans, pickup trucks, panel trucks, and trucks of that nature generally are not subject to highway use tax.

The tax applies if a vehicle is used on public highways in the United States more than 5,000 miles (7,500 miles for agricultural vehicles) a year. A public highway is any road in the United States that is not a private roadway. Canadian and Mexican heavy vehicles operated on U.S. highways are liable for this tax. For more information, see the instructions for Form 2290, and Publication 349, *Federal Highway Use Tax on Heavy Vehicles.*

Registration of vehicles. As an owner of heavy trucks, you must generally prove that you have paid your federal highway use tax before state motor vehicle departments will register any taxable vehicle. Generally, a copy of Schedule 1 of Form 2290, stamped after payment and returned to the owner by the IRS, is acceptable proof of payment.

ATF Form 5630.5— Alcohol, Tobacco, and Firearms. A number of excise taxes apply to alcoholic beverages, tobacco products, and firearms. If you produce, sell, or import guns, tobacco, or alcoholic products, or if you manufacture equipment for their production, you may be liable for one or more excise taxes. Form 5630.5, *Special Tax Registration and Return,* is used to register your place of business and pay an annual tax. The businesses covered by the form include:

1) Brewers and dealers—liquor, wine, or beer,
2) Distillers, importers, wholesale and retail dealers of distilled spirits,
3) Manufacturers that use alcohol to produce non-beverage products,
4) Manufacturers, importers, and dealers in firearms (National Firearms Act), and
5) Importers and wholesalers of imported perfumes.

For more information, see the instructions for ATF Form 5630.5.

For additional information on these and other taxes that apply to alcohol, tobacco, and firearms, write to:

The Director
Bureau of Alcohol, Tobacco and Firearms
Washington, DC 20226

Forms 730 and 11–C— Wagering. If you are in the business of accepting bets or running a betting pool or lottery, you may be liable for federal taxes on wagering. Form 730, *Tax on Wagering,* is used to report a tax on the bets you receive. Form 11–C, *Special Tax Return and Application for Registry—Wagering,* is used to pay an annual tax and register your place of business. For more information, see the instructions to these forms.

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36. Information Returns

Information returns are forms that provide information required by the Internal Revenue Service (IRS) other than amounts of tax due. There are four main categories of information returns:

1) Information returns of persons subject to special provisions of the law. For example, returns showing income, deductions, and distributions of:
   - Partnerships (discussed in Publication 541, *Tax Information on Partnerships*);
   - Exempt organizations (discussed in publication 557, *Tax-Exempt Status for Your Organization*); and
   - S corporations (discussed in Publication 589, *Tax Information on S Corporations*).
2) Information returns of employers reporting wages and other payments to employees (discussed in Publication 937, *Business Reporting,* and Circular E (Publication 15), *Employer's Tax Guide*).
3) Information returns of employee benefit plans (discussed in Publication 1048, *Filing Requirements for Employee Benefit Plans*).
4) Information returns for payments to nonemployees and transactions with other persons.

This chapter discusses the fourth category and provides general information about the forms and requirements for reporting payments to nonemployees and transactions with other persons.

Corporations and partnerships. Reporting is not generally required for payments to corporations except for:

1) Medical payments;
2) Withheld federal income tax or foreign tax;
3) Barter exchange transactions;
4) Substitute payments in lieu of dividends and tax-exempt interest; and
5) Interest or original issue discount paid or accrued to a regular interest holder of a real estate mortgage investment conduit (REMIC).

Treat a payee as a corporation if the payee's name ends with the corporate status, such as *Incorporated, Inc., Corporation,* or *Corp.* Do not treat a payee as a corporation if the payee's name ends with *Company* or *Co.* or without any business status.

However, reporting is required for payments to partnerships.

Nominee or middleman returns. If you receive an information return for money that belongs to another person, you should file the same type of information return showing the actual owner as the recipient and you as the payer.

Forms. The forms used to report payments to nonemployees and transactions with other persons are:

1) The Form 1099 series, which covers the reporting of ordinary kinds of payments made, and
2) Other forms specifically designed for reporting certain payments made, certain payments received, and certain other transactions.

Filing them. For information on when and how to file Forms W-2G, 1098, and forms in the 1099 series, see *When and How to File Information Returns,* later. For information on filing Forms 4789, 5498, 8300, and 8308, see the discussions of these forms later.

The Form 1099 Series

This series of forms is used to report ordinary kinds of payments made such as dividends, interest, and retirement distributions, as well as other payments and transactions. The various forms in this series and their uses are described in the following paragraphs.

Form 1099–A

File Form 1099–A, *Information Return for Acquisition or Abandonment of Secured Property,* if, in connection with a trade or business, you lend money and, in full or partial satisfaction of the debt, you:

1) Acquire an interest in property that is security for the debt; or
2) Have reason to know that the property has been abandoned.

A governmental unit that lends money secured by property must also file Form 1099–A.

Property. Property means real property, such as a personal residence, or tangible personal property held for investment or used in a trade or business. You are not required to report a loan made to an individual and secured by an interest in tangible personal property that is neither held for investment nor used in a trade or business.

For the reporting requirements on Form 1099–A, property also includes intangible property.

Abandonment. Property is considered abandoned when it can be shown that the borrower has permanently discarded the property from use. A lender "has reason to know" of an abandonment based on all the facts and circumstances concerning the status of the property. A lender is deemed to know all the information that would have been discovered through a reasonable inquiry when, in the ordinary course of business, the lender should become aware of circumstances indicating that the property was abandoned.

Form 1099–B

File Form 1099–B, *Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions,* if you do business as a broker (other than a real estate broker) or as a barter exchange and you:

1) Sell stocks, bonds, commodities, regulated futures contracts, forward contracts, debt instruments, etc.; or
2) Exchange property or services through a barter exchange.

Real estate transactions are reported on Form 1099–S, discussed later.

Brokers (other than real estate brokers) and barter exchanges. Brokers and barter exchanges must use magnetic media in reporting Form 1099–B data to IRS. New brokers and barter exchanges may request an undue hardship exception. See *When and How to File Information Returns,* later.

A "broker" is a person who, in the ordinary course of a trade or business, carries out sales made by others. For a sale of securities through a "cash on delivery" or similar account, only the broker who receives the gross proceeds from the sale against delivery of the securities sold is required to report the sale.

A person who manages a farm on behalf of another person is not treated as a broker. Thus, farm managers are not required to file Form 1099–B for their farm management activities.

You must report all sales as occurring on the trade date (the date you enter the sale on your books) and not the settlement date.

A "barter exchange" is any organization with members or clients that contract either with each other or with the organization to trade or barter property or services either directly or through the organization. The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.

Persons who are not a barter exchange but who trade services do not file Form 1099–B. However, they must file Form 1099–MISC, *Statement for Recipients of Miscellaneous Income,* discussed later, if the transaction is done in the course of a trade or business and the property or service traded or bartered has a fair market value of $600 or more. See *Example 5* under *Form 1099–MISC* for reporting an informal exchange of services that was not made through a barter exchange.

In the boxes on Form 1099–B for information on the recipient, barter exchanges are to show information on the member or client that provided the property or services in the transaction.

Example. Mr. Smith and Mr. Jones are members of a barter club. Club members pay initiation fees and annual dues, and agree to provide specific services to any member for a specified number of hours. Club membership gives each member access to a directory that lists club members and the variety of services available to members. There is no requirement that members provide services unless requested by another member. Members may use as many of the offered services as they wish without fee, but members receiving services that include materials are required to reimburse the provider's cost in cash. Members contact each other directly and request services to be performed.

However, the provider of the services must contact the barter club after the services are completed and furnish the name of the recipient and the fair market value of the services performed. The club then credits the provider's account with the value of the services performed, debits the recipient's account the same amount, and charges the recipient a 10% commission on the value of the services performed.

Mr. Smith's television set failed to work. He phoned Mr. Jones, a television repairman, and asked him to repair the set. Mr. Jones repaired the set in half an hour using parts that cost $25, and Mr. Smith paid him $25. Mr. Jones' usual charge is $15 for the home visit plus $15 for each half hour plus parts. The barter club must report $30, the fair market value of the services provided to Mr. Smith by Mr. Jones, to IRS on Form 1099–B and furnish a statement to Mr. Jones.

Form 1099–DIV

File Form 1099–DIV, *Statement for Recipients of Dividends and Distributions,* if you are a payer of dividends and you:

1) Paid $10 or more to another person in gross dividends and other distributions on stock;
2) Withheld foreign tax eligible for the recipient's foreign tax credit on dividends and other distributions on stock;
3) Withheld federal income tax on dividends and other distributions under the backup withholding rules; or
4) Paid $600 or more for distributions made as part of a liquidation.

If you receive dividend payments of $10 or more as a nominee or middleman for another person and you pay them to any other person, you must file Form 1099–DIV.

Certain payments often referred to as dividends are actually interest and are reported on Form 1099–INT, *Statement for Recipients of Interest Income,* discussed later. These include so-called dividends on deposit or share accounts in cooperative banks, credit unions, domestic and federal savings and loan associations, and mutual savings banks.

A dividend is generally any distribution made by a corporation to its stockholders from the accumulated earnings and profits of the corporation or from the corporation's annual earnings and profits.

Form 1099–G

File Form 1099–G, *Statement for Recipients of Certain Government Payments,* if, as a unit of a federal, state, or local government, you:

1) Made certain payments, such as unemployment compensation and state and local income tax refunds; or
2) Withheld federal income tax under the backup withholding rules.

Form 1099–INT

File Form 1099–INT, *Statement for Recipients of Interest Income,* if you are a payer of interest and you:

1) Paid or credited interest of $10 or more on earnings from savings and loan associations, credit unions, bank deposits, corporate bonds, etc. (also include interest of $600 or more from sources other than

those listed if in the course of your trade or business);

2) Withheld foreign tax eligible for the recipient's foreign tax credit on interest;
3) Had original issue discount on short-term obligations of one year or less, or paid interest on bearer certificates of deposit; or
4) Withheld federal income tax on interest under the backup withholding rules.

Only report interest payments made in the course of your trade or business (including governmental agencies and nonprofit organizations), or for which you were a nominee or middleman, or from which you withheld federal income tax or foreign tax.

Form 1099–MISC

In your trade or business activities, you may make payments that are not wages that you must report to the IRS. Form 1099–MISC, *Statement for Recipients of Miscellaneous Income,* is the information return used most often by a small business to report these payments.

File Form 1099–MISC if you:

1) Made payments of $600 or more for fees, commissions, or other forms of payments to persons not treated as your employees for services rendered in your trade or business;
2) Gave prizes, awards, or made other payments of $600 or more that are not for services rendered in your trade or business, or made direct sales of $5,000 or more of consumer products for resale;
3) Made payments of $10 or more for royalties, or $600 or more for rents other than rent payments to real estate agents;
4) Withheld federal income tax on miscellaneous income under the backup withholding rules;
5) Made payments of $600 or more to physicians or other suppliers or providers of health care services in connection with medical assistance programs, or health, accident, and sickness insurance programs;
6) Made payments in connection with the sale of a fishing catch, or made a distribution in-kind reported at the fair market value of the catch, to each crew member of fishing boats with normally fewer than 10 members; or
7) Received payments of $10 or more as a broker on behalf of a customer, in lieu of a dividend or tax-exempt interest, as a result of the transfer of a customer's securities for use in a short sale.

Report only payments made in the course of your trade or business (including government agencies and nonprofit activities), or from which you withheld federal income tax or foreign tax.

Payments include the fair market value of exchanges of property or services between individuals in the course of a trade or business. (If the exchange is made through a barter exchange, see *Form 1099–B,* earlier.)

Royalty payments. Examples of royalty payments to be reported on form 1099–MISC include payments for the right to exploit natural resources, such as oil, gas, coal, timber, sand, gravel, and other mineral interests. Also included are payments for the right to exploit intangible property, such as copyrights, trade names, trademarks, franchises, books and other literary compositions, musical compositions, artistic works, secret processes or formulas, and patents.

Nonemployee compensation. Payments that must be reported on Form 1099–MISC as nonemployee compensation include fees, commissions, prizes, awards, or other forms of compensation for services rendered for your trade or business by an individual who is not your employee.

If the following four conditions are met, a payment is generally reported as nonemployee compensation:

1) You made the payment to a nonemployee;
2) You made the payment for services rendered in your trade or business, including government agencies and nonprofit organizations;
3) You made the payment to a payee who is not a corporation. If the payment was made to a corporation, see *Corporations and partnerships,* earlier; and
4) You made payments to the payee totaling $600 or more during the year. Total payments include payments for parts or materials used by the payee in rendering the services.

Payments exempt from these requirements. Payments that do not require a Form 1099–MISC include the following:

1) Payments for merchandise and inventory, including freight, storage, and similar charges;
2) Payments for utilities, such as electricity, gas, oil, and water;
3) Payments for telephone, telegraph, and similar services;
4) Payments of rent to real estate agents;
5) Payments to employees (including federal, state, and local government employees) for traveling and other business expenses to the extent that the employees account to you for such expenses;
6) Payments to corporations except for those payments indicated earlier in this chapter; and
7) Payments to informers for information about criminal activities, but only if these payments are made by federal, state, or local agencies, or by non-profit organizations described in section 501(c)(3) of the Internal Revenue Code.

Examples. The following examples illustrate the filing of information returns for miscellaneous payments.

Example 1. Mrs. Taylor, an attorney, obtains the assistance of Mr. Johnson, another attorney, in serving a client. In return for the assistance, Mrs. Taylor agrees to split the fee received from the client with Mr. Johnson. Mrs. Taylor pays a $900 fee to Mr. Johnson. Mrs. Taylor must report $900 to IRS on Form 1099–MISC and furnish a statement to Mr. Johnson (a copy of Form 1099–MISC may be used for this purpose).

Example 2. Mr. Adams, a real estate agent in New York, refers a customer to Mrs. Williams, a real estate agent in California. Mrs. Williams sells a house to the customer and pays a $700 referral commission to Mr. Adams. Mrs. Williams must report $700 on Form 1099–MISC.

Example 3. An insurance company pays $1,000 to an unincorporated auto repair shop for a repair. The repair contract states that $300 is for labor and $700 is for parts. The insurance company must report the entire $1,000 on Form 1099–MISC. In this situation, the obligation to furnish parts is incidental to the obligation to repair the car.

Example 4. Mr. Black, a real estate agent, collected $1,000 in rental payments from the tenants of a building. He deducted his commission of $100 and paid $900 to the building owner. He must report the gross amount of $1,000 on Form 1099–MISC even though he deducted his commission of $100 from the $1,000 and paid the owner $900.

Example 5. An attorney and a painter agree to an exchange of services whereby the attorney represents the painter for non-payment of business debts in return for painting the attorney's law offices. The fair market value of the services performed by each is $1,000. The attorney and the painter are not incorporated, and the agreement is not made through a barter exchange. See *Form 1099–B* for transactions made through a barter exchange. The attorney must report $1,000 on Form 1099–MISC, and the painter must also report $1,000 on Form 1099–MISC.

In this situation, the attorney's payment in services to the painter (representing the painter for non-payment of business debts) is for a business expense of the attorney (painting the law offices). The painter's payment in services to the attorney (painting the attorney's law offices) is for a business expense of the painter (representation for non-payment of business debts). Each is making a payment for expenses incurred in the course of a trade or business.

Note: In the above example, if the attorney represented the painter in a divorce proceeding, the painter would not have to report $1,000 because the painter's services for the attorney would be payment for a personal rather than business expense of the painter. This is true even though the painter's services are of the kind normally performed in the course of his business. However, the attorney would still report $1,000 on Form 1099–MISC, because the attorney's services to the painter are made as a payment for an expense incurred in the course of the attorney's business.

Example 6. Mr. Jones is in the business of renting houses. He pays Mr. Smith, who operates a painting business as a sole proprietor, $1,750 to paint one of his rental houses. Mr. Jones must report the $1,750 on Form 1099–MISC.

Form 1099–OID

File Form 1099–OID, *Statement for Recipients of Original Issue Discount,* if you:

1) Issued any outstanding bond or other evidence of indebtedness in registered or bearer form with original issue discount of $10 or more;
2) Issued certificates of deposit made, purchased, or renewed after 1970, if there is original issue discount of $10 or more and the term of the obligation or deposit arrangement is more than one year;
3) Are a financial institution and have deposit arrangements, such as time deposits or bonus-savings plans with a term in excess of one year if the payment of interest is $10 or more and deferred until maturity;

4) **Withheld federal income tax on original issue discount under the backup withholding rules; or**

5) Are a broker or other middleman and hold, as a nominee for the actual owner, obligations, including certificates of deposit, with original issue discount of $10 or more.

Original issue discount is the difference between the principal amount (stated redemption price at maturity) of a long-term debt instrument, such as a bond, and the issue price. All long-term obligations that pay no interest prior to maturity are presumed to be issued at a discount. Zero-coupon bonds are one example of such obligations.

Issuers, brokers, or other middlemen who do not use actual dates of ownership by holders in computing the discount are permitted to prepare a Form 1099–OID only for each holder of record of the obligations on the semiannual record date, if any, used by the corporation or its agent for the payment of stated interest, or if there is no such date, on June 30 and December 31. On each Form 1099–OID, you should treat each holder as having purchased the obligation at the original issue price on the issue date, and as owning the obligation on every day it was outstanding during the calendar year. However, for time deposits and face-amount certificates, use the actual date of deposit to compute original issue discount (OID).

Original issue discount on obligations with a term of one year or less should be reported on Form 1099–INT.

If regular interest is paid on a long-term OID instrument, in addition to the OID, this interest is reported on Form 1099–OID. It is not reported on Form 1099–INT.

For time deposits and face-amount certificates, use the actual date of deposit and compute OID on a straight line, monthly prorated basis for obligations issued before July 2, 1982, and on a daily economic accrual basis for obligations issued after July 1, 1982.

Publication 1212, *List of Original Issue Discount Instruments*, is available to enable brokers and other middlemen to identify publicly offered OID obligations they hold as nominees for the true owners. Issuers of publicly offered OID obligations must report directly to IRS on Form 8281, *Information Return for Publicly Offered Original Issue Discount Instruments*, within 30 days of the date of issuance. Publication 1212 also helps owners of original issue discount obligations determine how much OID to report on their income tax returns when the OID is less than the amount shown on Form 1099–OID.

Form 1099–PATR

File Form 1099–PATR, *Statement for Recipients (Patrons) of Taxable Distributions Received From Cooperatives*, if, as a cooperative, you:

1) Paid $10 or more in patronage dividends and other distributions described in section 6044(b) of the Internal Revenue Code; or
2) Withheld federal income tax on patronage dividends and other distributions under the backup withholding rules.

A patronage dividend is an amount paid by a cooperative to its patrons. The amount must be based on the quantity or value of business done with or for a patron. It must be paid under an existing written obligation of the cooperative to pay it and must be determined by reference to the net earnings of the cooperative from business done with or for its patrons.

Consumer cooperatives engaged primarily in retail sales of goods or services that are generally for personal, living, or family use may qualify for an exemption from filing Form 1099–PATR. To qualify for the exemption, 85% of the cooperative's gross receipts for the preceding tax year, or 85% of the total gross receipts for the preceding 3 tax years, must have been from retail sales of goods or services that are generally for personal, living, or family use. A cooperative that qualifies should apply for an exemption on Form 3491, *Consumer Cooperative Exemption Application*.

Form 1099–R

File Form 1099–R, *Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.*, if you made total distributions from:

1) Profit-sharing and retirement plans;
2) Individual retirement arrangements (IRAs); or
3) Simplified employee pension plans (SEPs).

If you are reporting a total distribution from a plan that includes a distribution of deductible voluntary employee contributions (DECs), file one Form 1099–R to report the DECs distribution and a second to report the distribution from the other part of the plan.

All of such total distributions must be reported on Form 1099–R regardless of the amount.

A total distribution is one in which the entire balance of the account is distributed. Payments that are not total distributions should be reported on Form W–2P, *Statement for Recipients of Annuities, Pensions, Retired Pay, or IRA Payments.*

Form 1099–S

File Form 1099–S, *Statement for Recipients of Proceeds From Real Estate Transactions*, for real estate transactions that closed in 1990 if you are the person required to report the sale or exchange of one-to-four-family real estate.

One-to-four-family real estate. This means a structure, such as a house, condominium, or apartment building that houses up to four families, or stock in a cooperative housing corporation.

Person required to report. You are generally required to report the real estate transaction if you are the person listed as the settlement agent on the closing statement or, if no settlement agent is listed, the person who prepares the closing statement. If no closing statement is used, the person responsible for closing is, in the order listed:

1) The buyer's (or transferee's) attorney if he or she actively participates in the transaction,
2) The seller's (or transferor's) attorney if he or she actively participates in the transaction, or
3) The title or escrow company that disburses the most money.

If no one is responsible for closing the transaction, as discussed above, the person required to report the real estate transaction is, in the order listed:

1) The mortgage lender,
2) The seller's broker,
3) The buyer's broker, or
4) The buyer.

Before January 31, 1991, the person required to report the transaction must furnish a statement to the seller containing the same information required to be reported to IRS. A copy of Form 1099–S may be used for this purpose. See *Statements for Recipients*, later.

Note. It is unlawful for the person required to report the transaction to make a separate charge to any customer for complying with the information reporting requirements.

Additional Information

For more information on forms in the 1099 series, see a booklet titled: *1990 Instructions for Forms 1099, 1098, 5498, and W–2G.*

Other Forms

The following forms are specifically designed for reporting certain payments made such as gambling winnings, certain payments received such as mortgage interest and large cash amounts, and certain other transactions.

Form W–2G

File Form W–2G, *Statement for Recipients of Certain Gambling Winnings*, at the time of the payment or on or before February 28, 1991, if you are a payer of gambling winnings and you:

1) Paid $600 or more in winnings from horse racing, dog racing, and jai alai, and in other winnings not referred to in (2), (3), or (4) below that are at least 300 times the amount wagered;
2) Paid $600 or more in winnings from lotteries, raffles, or drawings;
3) Paid $1,200 or more in winnings from bingo or slot machines; or
4) Paid $1,500 or more in winnings from keno after deducting the amount wagered.

Withholding requirements. You must withhold federal income tax of 20% from gambling winnings other than winnings from keno, bingo, and slot machines, if the proceeds (the amount of winnings less the amount wagered) are:

1) More than $5,000 from a state lottery;
2) More than $1,000 from a non-state-conducted lottery, wagering pool, or sweepstakes; or
3) More than $1,000 from horse racing, dog racing, jai alai, or other wagering transaction (except a lottery, sweepstakes, or wagering pool) with winnings that are at least 300 times the amount wagered.

Backup withholding. If the recipient of winnings that you are required to report (including winnings from keno, bingo, and slot machines) does not provide a taxpayer identification number, you must impose backup withholding at a 20% rate on any of the winnings not subject to regular gambling withholding. Backup withholding applies to all winnings (not subject to regular gambling withholding) reduced, at the option of the payer, by the amount wagered. It is ***not*** limited to winnings in excess of the Form W–2G filing requirement amounts of $600, $1,200, or $1,500.

At the time of the payment or by January 31, 1991, give a copy of the official Form W–2G, or a substitute form containing substantially similar language, to each winner.

Forms 1042 and 1042S. Payments of gambling winnings to a nonresident alien individual or a foreign corporation are not reported on Form W–2G. These payments are subject to withholding under sections 1441(a) and 1442(a) of the Internal Revenue Code, and are reported on Form1042S, *Foreign Person's U.S. Source Income Subject to Withholding*, and Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*.

Form 5754. If the person presenting the winning ticket for gambling winnings that are subject to withholding or reporting requirements is not the actual winner, or is a member of a group of two or more winners, that person must complete Form 5754. *Statement by Person(s) Receiving Gambling Winnings*.

If federal income tax is withheld, Form 5754 must be signed under penalties of perjury by the person receiving the winnings. Form 5754 must be returned to the payer so that the payer will have the information needed to prepare a Form W–2G for each of the persons listed as winners.

Additional Information. The requirements for filing Form W–2G depend on the type of gambling activity. For more information on Form W–2G, get a booklet titled: *1990 Instructions for Forms 1099, 1098, 5498, and W–2G*.

Form 1098

File Form 1098, *Mortgage Interest Statement*, by February 28, 1991, if, in connection with a trade or business, you receive mortgage interest of $600 or more from an individual on any one mortgage during a calendar year. A government unit and a cooperative housing corporation receiving mortgage interest of $600 or more from an individual must also file Form 1098.

No reporting is required for interest received from a corporation, partnership, trust, estate, association, or company (other than a sole proprietor).

For obligations in existence on December 31, 1984, a mortgage is any obligation secured primarily by real property located inside or outside the United States unless, at the time the obligation was incurred, you reasonably classified the obligation as other than a mortgage, real property loan, real estate loan, or other similar type of obligation. For example, if an obligation incurred in 1983 was secured by real property, but you reasonably classified the obligation as a commercial loan because the proceeds were used to finance the borrower's business, the obligation is not considered a mortgage for purposes of this reporting requirement.

For obligations incurred after 1984 but before 1988, a mortgage is any obligation secured primarily by real property located inside or outside the United States. That obligation is a mortgage for purposes of this reporting requirement even if the recipient classifies it as other than a mortgage, such as a commercial loan.

For obligations incurred after 1987, a mortgage is any obligation secured all or in part by real property located inside or outside the United States even though you classify it as other than a mortgage.

Real property includes stock in a cooperative housing corporation. It also includes any manufactured home with a minimum living space of 400 square feet and a minimum width of more than 102 inches, including certain mobile homes, customarily used at a fixed location.

If you receive reportable interest payments on behalf of someone else, such as a servicing bank collecting payments for a lender, you must file this form. The person for whom you receive the interest need not file, and no additional reporting on Form 1098 is required for the transfer of the interest from the servicing bank to the lender.

Lines of credit and credit card obligations. If you received interest on a mortgage after 1987 in the form of a line of credit or a credit card obligation, this interest must be reported as mortgage interest regardless of how you classified it.

Additional Information. For more information on Form 1098, get a booklet titled: *1990 Instructions for Forms 1099, 1098, 5498, and W–2G*.

Form 4789

Each financial institution other than a casino must file a Form 4789, *Currency Transaction Report*, for each deposit, withdrawal, exchange of currency, or other payment or transfer, by, through, or to the financial institution, that involves a transaction in currency of more than $10,000. Multiple transactions by or for any person that total more than $10,000 in any one day should be treated as a single transaction if the financial institution is aware of them.

For purposes of Form 4789, a financial institution includes:

1) A bank;
2) A broker or dealer in securities;
3) A person in the business of dealing in or exchanging currency including a check casher;
4) A person who issues, sells, or redeems traveler's checks, money orders, or similar instruments (except as provided in 31 CFR 103.11);
5) A person in the business of transmitting funds;
6) A telegraph company; and
7) The U.S. Postal Service with respect to selling money orders.

A currency transaction means the physical transfer of cash from one person to another. It does not include a transfer of funds by bank check, bank draft, wire transfer, or other written order.

The financial institution must file Form 4789 by the 15th day after the date of the transaction with the Internal Revenue Service at the address shown on the form, or hand carry it to a local IRS office by that date. The financial institution should keep a copy of each Form 4789 for 5 years from the date it is filed.

Penalties. Civil and criminal penalties, including a fine of up to $500,000 and up to 10 years in prison, are provided for not filing Form 4789 or for filing a false or fraudulent form.

Form 5498

File Form 5498, *Individual Retirement Arrangement Information*, by May 31, 1991, with IRS for each person for whom you maintained during 1990:

1) Individual retirement arrangements (IRAs); or
2) Simplified employee pension plans (SEPs).

For a SEP, furnish only the fair market value of the account. Do not report employer SEP contributions on Form 5498. For an IRA, report any contributions made for 1990 and show the fair market value of the account (even if no contributions were made). For contributions made between January 1 and April 15, 1991, trustees and issuers should obtain the participant's designation of the year for which the contributions are made. Trustees or issuers of endowment contracts having a life insurance feature must separately show the contributions allocable to life insurance.

For reporting purposes, contributions and rollovers do not include direct transfers between trustees (or issuers) that involve no payment or distribution of funds to the participant.

If you are a trustee or issuer of an IRA or SEP, you must provide each participant with a statement of the value of his or her account by January 31, 1991, and with contribution information by May 31, 1991. You are not required to provide information as to whether or not a contribution is deductible.

If you furnished a statement of the fair market value of an IRA to the participant by January 31, 1991, as required, and no IRA contributions were made for 1990, you need not furnish Form 5498 to the participant by May 31, 1991, to report zero contributions. However, you must file Form 5498 by May 31, 1991, to report the fair market value of the IRA at the end of 1990.

If a total distribution was made from an IRA during 1990 and no contributions were made for 1990, you need not file Form 5498 to show that the fair market value at the end of 1990 was zero.

Distributions from IRAs and SEPs are reported on Form 1099–R or W–2P. For a distribution of excess contributions plus earnings, report the distribution on a Form 1099–R or W–2P, whichever applies.

Form 8300

File Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, if, in connection with a trade or business, you receive more than $10,000 in cash or foreign currency in one or more related transactions.

Note: This reporting requirement does not apply to financial institutions that must report cash transactions of over $10,000 to IRS on Form 4789, *Currency Transaction Report*, and casinos that must report such transactions to IRS on Form 8362, *Currency Transaction Report by Casinos*. Casinos in Nevada that are exempt from filing Form 8362 are also exempt from filing Form 8300.

A transaction means the physical receipt of cash from a payer for the purchase of goods, services, personal or real property, and intangible property; a debt obligation paid with cash; the receipt and conversion of cash to a negotiable instrument; and the receipt of cash to be held in escrow or trust.

File Form 8300 by the 15th day after the date of the transaction with the Internal Revenue Service at the address shown on the form, or hand carry it to your local IRS office by that date. Keep a copy of each Form 8300 for 5 years from the date it is filed.

For the calendar year in which you file a Form 8300, you must give to each person named on it a written statement by January 31 of the following year. The statement must show the name and address of your business and the total amount of cash received from the payer during the year. It must also state that the information is being furnished to IRS. If you had a single transaction with a payer during the year, you can use a copy of your filed Form 8300 as the statement.

Penalties. Civil and criminal penalties, including up 5 years in prison, are provided for not filing Form 8300 or for filing (or causing the filing) of a false or fraudulent form.

Form 8308

A partnership must file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests,* with its partnership return to report a sale or exchange of a partnership interest involving unrealized receivables or substantially appreciated inventory items. The partnership does not have to file Form 8308 until the partnership has notice of this exchange. The transferor of such a partnership interest must give written notice of it to the partnership within, generally, 30 days of the exchange. If a partnership is notified of an exchange after it has filed its Form 1065, Form 8308 must be filed separately within 30 days of the notification.

The partnership must attach one Form 8308 to its Form 1065, *U.S. Partnership Return of Income,* for each sale or exchange of a partnership interest involving unrealized receivables or substantially appreciated inventory items. It must also give a copy of Form 8308 to each person named on Form 8308 by January 31, 1991, for calendar year 1990. For more information, see the instructions for Form 8308 and Publication 541, *Tax Information on Partnerships.*

Note: Form 8308 does not have to be filed if Form 1099–B, *Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions,* must be filed for the sale or exchange.

When and How to File Information Returns

File the forms in the 1099 series on or before February 28, 1991. Also, file forms W–2G and 1098 by this date. Transmit these forms to IRS with Form 1096, *Annual Summary and Transmittal of U.S. Information Returns.* You must use a separate Form 1096 for each type of form.

Send Form 1096 and the appropriate information returns to your Internal Revenue Service Center. The service center addresses are listed in a booklet titled: *1990 Instructions for Forms 1099, 1098, 5498, and W–2G.*

For information on filing Forms 4789, 5498, 8300, and 8308, see the sections on those forms earlier in this chapter.

Magnetic media. If you file at least 250 information returns, you must use magnetic media unless you establish that this requirement would result in undue hardship. The 250 return requirement applies separately to each form.

Send all information returns filed on magnetic media to:

Internal Revenue Service
Martinsburg Computing Center
P.O. Box 1359
Martinsburg, WV 25401–1359.

Revenue procedures for magnetic media reporting are available at Internal Revenue Service Centers and District Offices.

Approvals. If you must or want to file on magnetic media, you must first receive approval from IRS. To do so, file Form 4419, *Application for Magnetic Media Reporting of Information Returns,* at least 90 days before filing the returns. IRS will provide you with a written reply and further instructions.

Hardship requests. You can use Form 8508, *Request for Waiver From Filing Information Returns on Magnetic Media,* to request a waiver of the magnetic media filing requirements. You cannot apply for a waiver for more than one year at a time. Separate requests must be filed for each type of form, and the request must be filed at least 90 days before the due date of the returns.

Extension. If you are unable to file information returns with IRS on either paper forms or magnetic media by the due date, get Form 8809, *Request for Extension of Time To File Information Returns.* You must, however, furnish the required statements to recipients by the due date.

Statements for Recipients

Be sure that the statements you provide to recipients are clear and legible.

If you make payments of dividends, patronage dividends, and interest, you must furnish an official Form 1099 statement to each payee either by first class mail or in person. Payers of royalties must also furnish a statement to each payee either by first class mail or in person. The statement need not be on the official form. You can include in your statement mailing sent by first class mail (or interoffice mail) the following enclosures:

1) Form W–8 and Form W–9 requests, and other Forms 1099, Form 1098, and Form 5498 payee statements,
2) Form W–2 and Form W–2P payee statements,
3) A check or a letter explaining why no check is enclosed,
4) A letter explaining the tax consequences of the information shown on an enclosed payee statement, and
5) A statement of the payee's account.

A payee statement may be attached, with a line of holes for separation, to a check or account statement showing payments on the payee's account. The enclosure to which the payee statement is attached must contain, in bold and conspicuous type, the legend "Important Tax Return Document Attached."

No enclosures other than those mentioned above and no advertising or promotional material are permitted in the mailing of statements to recipients.

In general, the envelope must state on the outside in a conspicuous manner the legend "Important Tax Return Document Enclosed." The check, letter, or account statement must also contain this legend in a conspicuous manner. However, this legend is not required on the outside of the envelope or on the enclosures if (as previously required) the envelope only contains payee statements, Forms W–8 and W–9 requests, and a letter explaining the tax consequences of the information shown on an enclosed payee statement.

You can use substitute Forms 1099 if they contain the same language as the official forms and comply with the revenue procedures for substitute Forms 1099.

The recipient's copy of substitute Forms 1099 (Copy B) for payments of dividends or interest must contain the statement "This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported." The substitute form must also contain the instructions on the back of Copy B of the official form.

For information reported on Forms 1098, 1099–A, 1099–B, 1099–G, 1099–MISC (except for royalties), 1099–R, 1099–S, 5498, or W–2G, the statement to the recipient need not be a copy of the paper form filed with IRS. You may combine the statements with other reports or notices, or expand them to include other information of interest to the recipient. Be sure to provide the recipient with applicable instructions similar to those on the back of the recipient's copy of the official IRS form.

For more information about paper substitutes, see Publication 1179, *Specifications for Paper Document Reporting and Paper Substitutes for Forms 1096, 1098, 1099 Series, 5498, and W–2G.*

Time for furnishing statements. You must generally provide Forms 1098, 1099, and W–2G information by January 31 of the following year. However, you may issue them earlier in some situations. For example, you may furnish Form 1099–INT to the recipient on redemptions of U.S. Savings Bonds at the time of redemption. Cooperatives may furnish Forms 1099–PATR with the final dividend payment regardless of the date. Brokers and barter exchanges may furnish Form 1099–B at any time, but not later than January 31.

Form 5498 information. If you are a trustee or issuer of an IRA or SEP, you must provide each participant with a statement of the value of his or her account by January 31, 1991, and with contribution information by May 31, 1991.

Backup Withholding

In certain cases, you may be required to withhold income tax at 20% (backup withholding) on payments of interest, dividends, patronage dividends, rents, royalties, commissions, nonemployee compensation, and certain other payments you make in the course of your trade or business. In addition, transactions by brokers and barter exchanges and certain payments made by fishing boat operators are subject to backup withholding. Real estate transactions, however, are not subject to backup withholding.

You must withhold 20% of the payment if the payment is a reportable interest, dividend, or other payment and:

1) The payee does not furnish a taxpayer identification number (TIN) to you;
2) IRS notifies you that the payee furnished an incorrect TIN;
3) You are notified by IRS that the payee is subject to backup withholding on interest or dividends;
4) For interest and dividend accounts opened (or instruments acquired) after 1983, the payee does not certify to you, under penalties of perjury, that he or she is not subject to backup withholding under item (3) above; or
5) For interest, dividend, broker, or barter exchange accounts opened (or instruments acquired) after 1983, or broker accounts considered inactive in 1983, the payee does not certify to you, under penalties of perjury, that the TIN furnished is correct.

Note: For information on backup withholding on gambling winnings, see *Form W–2G*, earlier.

You can use Form W–9, *Request for Taxpayer Identification Number and Certification*, to request payees to furnish a taxpayer identification number and to certify that the number furnished is correct.

You can also use Form W–9 to obtain certifications from payees that they are not subject to backup withholding or that they are exempt from backup withholding. Form W–9 includes a list of payees who are exempt from backup withholding.

Form W–8, *Certificate of Foreign Status*, is used by nonresident aliens and foreign entities to certify that they are not subject to U.S. information return reporting or backup withholding rules on payments of interest, broker transactions, or barter exchange transactions. Payers of interest, brokers, and barter exchanges should send Form W–8 to nonresident alien individuals and foreign corporations, partnerships, estates, and trusts to obtain this certification.

Length of backup withholding period. Generally, the period for which the 20% backup withholding should be withheld is as follows:

1) ***Taxpayer identification number (TIN) not furnished.*** Withhold on payments made until the TIN is furnished unless the payee is waiting for a TIN. The payee may certify on Form W–9 that he or she is waiting for a TIN by writing "Applied for" in the space for a TIN and signing the form. If the TIN is not received within 60 days, begin withholding and continue until a TIN is furnished.

   During this 60-day period, you must backup withhold either on:

   - Any withdrawals of reportable interest and dividends made after the 7th business day after you receive the awaiting-TIN certificate, or
   - Any payments of reportable interest and dividends made during the 60-day period (whether or not a withdrawal is made). Under this method, you must (1) begin backup withholding no later than the 7th business day after you receive the awaiting-TIN certificate, and (2) refund the amounts withheld if the TIN is received during the 60-day period.

2) ***No certification by payee that the TIN is correct.*** Withhold on reportable interest and dividends until you receive the certification. If the payee does not have a TIN, see (1) above.
3) ***No certification by payee that he or she is not subject to backup withholding.*** Withhold on reportable interest and dividends until the certification is provided.
4) ***Notice from IRS that payee is subject to backup withholding.*** Start withholding on payments made after the 30th day from the date you receive notification from IRS. Stop withholding when you receive a written IRS notice to stop from IRS or from the payee. You must notify the payee when withholding under this procedure starts. In most cases, withholding will stop on January 1 of the year following the year of the notice.
5) ***Notice from IRS that payee furnished an incorrect TIN.*** Start withholding on payments made more than 30 business days after the date you receive notification from IRS. (You may elect to withhold on payments made at any time after receiving the notification from IRS.) Stop withholding within 30 calendar days after a certified TIN is furnished.

Note: If you filed information returns reporting interest, dividends, patronage dividends, or original issue discount for 1990 with an incorrect TIN, IRS may require you to withhold income tax from reportable payments in 1991.

A TIN will be considered incorrect if:

- The TIN does not match any number on IRS or Social Security Administration (SSA) records, or
- The TIN matches a number on an IRS or SSA record, but the name associated with the TIN does not match the name on the information return.

If you receive an IRS notice of an incorrect TIN for a prior year's return, you must send a copy of the notice and a Form W–9 to the payee and notify the payee of the following:

- The IRS has determined that the TIN furnished by the payee is incorrect, and
- The payee is subject to income tax withholding at 20% on each reportable payment.

Start withholding on payments you make after the 30th day from the date you receive notification from IRS. Stop withholding when you receive a certified TIN or certified TIN and name combination. If the payee gives you another certified TIN, use that TIN on information returns you are required to file.

Report amounts withheld under backup withholding on Form 941, *Employer's Quarterly Federal Tax Return* (or Form 941E, *Quarterly Return of Withheld Federal Income Tax and Hospital Insurance (Medicare) Tax)*. If you file Form 943, *Employer's Annual Tax Return for Agricultural Employees*, you must also report backup withholding on Form 941 (or Form 941E). You can combine these amounts with your employment taxes for deposit purposes. If you choose to treat them separately, you can show the backup withholding amounts on Schedule A (Form 941), *Record of Federal Backup Withholding Tax Liability*. At the end of the year, report these amounts on forms in the 1099 series.

Penalties

Beginning in 1990, the penalty for filing a late information return is based on the length of time the return is late. The penalty applies if you do not file by the due date, if you do not include all required information, or if you report incorrect information

Late information returns. The following penalties apply to late information returns:

1) If the return is filed within 30 days after the due date, the penalty is $15 for each return, up to a maximum of $75,000 a year.
2) If the return is filed after the 30-day period but by August 1, the penalty is $30 for each return, up to a maximum of $150,000 a year.
3) If the return is filed after August 1 or never filed, the penalty is $50 for each return, up to a maximum of $250,000 a year.

Small businesses pay the same penalty for a return, but the maximums are lowered to $25,000, $50,000, and $100,000 a year. A small business is one with average annual gross receipts of $5 million or less for the last 3 years ending before the calendar year the return is due, or since the business began if shorter.

Late payee statements. After 1989, if you do not furnish a required statement to a payee by the required date, there is a penalty of $50 for each statement you do not furnish, up to a maximum of $100,000 a year. The penalty also applies if you do not include all required information, or if you report incorrect information.

Other information reporting penalties. After 1989, there is a penalty of $50 for each failure to comply with certain specified information reporting requirements by the required date, up to a maximum of $100,000 a year for all such failures. Most of these requirements concern furnishing and including taxpayer identification numbers on returns, statements, and other documents.

Penalty waiver. For returns and statements due after 1989, no penalty will apply if you can show that the failure to perform a required act was due to reasonable cause and not to willful neglect.

Also, if errors are corrected by August 1, a penalty will not apply to a small number (or percentage) of returns that were filed with incomplete or incorrect information. The number is the greater of 10 returns or 1/2 of 1% of the total number of returns you are required to file for the year.

Part VIII
Filled-In Forms

The purpose of this Part is to familiarize you with the tax forms used to report business income or loss. The use of each form is illustrated by an example business and a discussion of how that business would fill out its tax return.

37. Schedule C— Sole Proprietorship

If you are the sole owner of an unincorporated business or a ***statutory employee*** (see Chapter 32), you must report business income and expenses on Schedule C (Form 1040). A sample Schedule C with Form 4562 and Schedule SE (Form 1040) for Susan J. Brown are illustrated on the following pages.

Susan J. Brown owns and operates Milady Fashions, a ladies ready-to-wear apparel shop. She uses the accrual method of accounting and files her return on a calendar year basis.

Five different employees worked in her shop during 1990. She had filed all the necessary employment tax forms and made the required tax deposits. See Chapter 33.

First Susan fills in the information required at the top of Schedule C. On line A she enters "Retail, ladies' apparel" and on line B she enters the 4–digit business code for a ladies apparel shop. These codes are found in Part IV on page 2 of Schedule C. Susan locates the major business category that describes her business. She reads down the items under "Retail Trade" to find the code that applies to her business. This is 3913—"Women's ready-to-wear stores." Susan enters 3913 on line B.

The line items below show how she filled in Schedule C for 1990:

Line 1. Susan had sales of $397,742 in 1990. She enters her total sales on line 1.

Line 2. On line 2, she enters the refunds she gave on merchandise her customers returned, as well as other adjustments she made to customers' purchases. They total $1,442.

Line 4. Susan uses Part III on page 2 of Schedule C to figure her cost of goods sold.

Part III, line 31. Her inventory at the beginning of 1990, $42,843, is the same as her inventory at the end of 1989. This figure matches the amount on Part III, line 38 of her 1989 Schedule C.

Part III, line 32. The total cost of goods she bought to sell to customers, minus the cost of the goods she returned to her suppliers, was $241,026. From this stock, she withdrew clothing and accessories for her own use that cost $774. She subtracts the cost of these items from her total purchases to figure net purchases of $240,252.

Part III, line 36. She then adds her net purchases to her beginning inventory. This sum is the total goods Susan had available for sale during the year.

Part III, line 37. Susan's inventory at the end of the year was $43,746.

Part III, line 38. Subtracting her inventory at the end of the year (line 37) from the goods that were available for sale (line 36) gives Susan the cost of goods sold during the year. For more information on inventories and cost of goods sold, see Chapters 4 and 8.

Line 5. Gross Profit, $156,951, is the difference between Susan's net sales (line 3) and the cost of goods sold (line 4).

Line 7. Because Susan did not have any income to report on line 6, the gross income is the same as the gross profit (line 5).

Line 8. Susan paid $3,500 for ads.

Line 9. During 1990, Susan determined that she would not be able to collect $479 from bad checks and deducted this amount as bad debts. See Chapter 14.

Line 10. Susan enters $2,250 for gas and oil for her van. She used the van 75% for business in 1990. She spent a total of $3,000 for gas and oil in 1990. She can deduct 75% of $3,000 or $2,250.

Line 13. Susan figures her depreciation on Form 4562. She bought and placed in service in her business on March 20, 1990, a van. The van weighs over 6,000 pounds; therefore, it is not a passenger automobile for the deduction limits. The van is 5–year property and the deduction is figured using the 200% declining balance method and a half-year convention under MACRS.

The van cost $8,667. Susan can depreciate 75% of $8,667 or $6,500. Susan did not elect to deduct any part of the cost of the van as a section 179 deduction. Since the van is listed property, Susan must complete Part V on page 2 of Form 4562. The depreciation for listed property from Part V is entered on line 19, Part IV of Form 4562.

Susan also bought and placed in service on May 19, 1990, a new adding machine and some clothing racks. The adding machine is 5–year property and the clothing racks are 7–year property. The adding machine cost $200 and the clothing racks cost $800.

Susan elects to deduct the cost of the adding machine as a section 179 deduction. The deduction for the clothing racks is figured using the 200% declining balance method and a half-year convention under MACRS. Susan must complete Part I and Part II of Form 4562.

For items bought after 1980 and before 1987, she uses the regular ACRS percentages. For items bought before 1981, she uses the straight line method. The total depreciation for these items appears on line 18, Part I of Form 4562. See Chapter 12.

Susan has no deduction for amortization. However, if she had recently acquired or set up the business, she could choose to deduct amortization for certain business start-up expenses. See Chapter 13.

Line 15. Susan's $950 deduction is for insurance on her business property (including 75% for van insurance). The deduction is only for premiums that give her coverage for 1990. See Chapter 17.

Line 16b. Susan had borrowed money to use in her business. The interest on these loans was $2,633 for 1990.

Line 18. The $216 Susan paid for postage in 1990 is her only office expense.

Line 20b. Her rent for the store was $1,000 a month, or $12,000 for the year.

Line 21. She had her store counters refinished and other painting was done at a total cost of $964. Repairs and upkeep of her van cost $812 (75% of $1,083). See Chapter 19.

Line 22. She spent $1,203 on supplies.

Line 23. Susan renewed her business license, paid property tax on her store fixtures, and got license tags for her van. She also paid the employer's share of social security tax for her employees, and paid state and federal unemployment taxes. She enters the total of all these taxes (75% for the tags), $5,802, on this line. See Chapter 16.

Line 25. Susan's total expense for heat, light, and telephone for the year is $3,570.

Line 26. Susan paid her employees a total of $63,450 for the year. She does not include in wages any amounts she paid to herself or withdrew from the business for her own use.

Susan has two employees whose wages qualify for the jobs credit. She figures the jobs credit on Form 5884, *Jobs Credit,* and uses it to reduce her income tax on Form 1040. However, Susan must subtract the credit of $4,400 from her wage and salary expense for the year. She figures her deductible salary expense to be $59,050 ($63,450 – $4,400) and enters this amount on line 26. See Chapter 31.

Since Susan has claimed only the jobs credit, she does not have to prepare Form 3800. The general business credit consists of the investment, jobs, research, low-income housing, and alcohol fuel credits. If you have more than one of these credits, or a carryforward or carryback of any of these credits, you must summarize them on Form 3800.

Line 27. Susan enters other business expenses here that are not listed separately on the schedule. See Chapter 19.

Line 28. Susan adds all her deductions listed in Part II and enters the total on this line.

Line 29. She subtracts her total deductions (line 28) from her gross income (line 7). Susan has a net profit of $52,713. She enters her net profit here, on line 12 of Form 1040, and on line 2 of Schedule SE (Form 1040).

Line 30. Susan does not have a loss, so she skips this line. If she had a loss and she was not "at risk" for all of her investment in the business, the amount of loss she could enter on line 12 of Form 1040 might be limited. See Chapter 20 and the instructions for Schedule C for an explanation of an investment "at risk."

SCHEDULE C
(Form 1040)

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business
(Sole Proprietorship)
Partnerships, Joint Ventures, Etc., Must File Form 1065.
▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074
1990
Attachment Sequence No. 09

Name of proprietor: Susan J. Brown
Social security number (SSN): 111 00 1111

A Principal business or profession, including product or service (see Instructions): Retail, ladies' apparel

B Enter principal business code (from page 2) ▶ 3 9 1 3

C Business name and address (include suite or room no.) ▶ Milady Fashions
725 Big Sur Drive Franklin, NY 18725

D Employer ID number (Not SSN): 1 0 1 2 3 4 5 6 7

E Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☑ Other (specify) ▶ Hybrid

F Method(s) used to value closing inventory: (1) ☑ Cost (2) ☐ Lower of cost or market (3) ☐ Other (attach explanation) (4) ☐ Does not apply (if checked, go to line H)

		Yes	No
G	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? (If "Yes," attach explanation.)		✓
H	Are you deducting expenses for business use of your home? (If "Yes," see Instructions for limitations.)		✓
I	Did you "materially participate" in the operation of this business during 1990? (If "No," see Instructions for limitations on losses.)	✓	

J If this is the first Schedule C filed for this business, check here ▶ ☐

Part I Income

1	Gross receipts or sales. *Caution: If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see the Instructions and check here* ▶ ☐	1	397,742
2	Returns and allowances	2	1,442
3	Subtract line 2 from line 1. Enter the result here	3	396,300
4	Cost of goods sold (from line 38 on page 2)	4	239,349
5	Subtract line 4 from line 3 and enter the **gross profit** here	5	156,951
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see Instructions)	6	-0-
7	Add lines 5 and 6. This is your **gross income** ▶	7	156,951

Part II Expenses

8 Advertising	8	3,500	21 Repairs and maintenance	21	1,776
9 Bad debts from sales or services (see Instructions)	9	479	22 Supplies (not included in Part III)	22	1,203
			23 Taxes and licenses	23	5,802
10 Car and truck expenses (attach Form 4562)	10	2,250	24 Travel, meals, and entertainment:		
11 Commissions and fees	11		a Travel	24a	
12 Depletion	12		b Meals and entertainment		
13 Depreciation and section 179 expense deduction (not included in Part III) (see Instructions)	13	2,731	c Enter 20% of line 24b subject to limitations (see Instructions)		
14 Employee benefit programs (other than on line 19)	14		d Subtract line 24c from line 24b	24d	
15 Insurance (other than health)	15	950	25 Utilities	25	3,570
16 Interest:			26 Wages (less jobs credit)	26	59,050
a Mortgage (paid to banks, etc.)	16a		27a Other expenses (list type and amount):		
b Other	16b	2,633	Bank Services Charges 180		
17 Legal and professional services	17		Chamber of Commerce 60		
18 Office expense	18	216	Free Credit Card Co 6,000		
19 Pension and profit-sharing plans	19		Trash removal 1,600		
20 Rent or lease (see Instructions):			Window washing 238		
a Vehicles, machinery, and equip.	20a				
b Other business property	20b	12,000	27b Total other expenses	27b	8,078

28	Add amounts in columns for lines 8 through 27b. These are your **total expenses** ▶	28	104,238
29	**Net profit or (loss).** Subtract line 28 from line 7. If a profit, enter here and on Form 1040, line 12. Also enter the net profit on Schedule SE, line 2 (statutory employees, see Instructions). If a loss, you MUST go on to line 30 (fiduciaries, see Instructions)	29	52,713

30 If you have a loss, you MUST check the box that describes your investment in this activity (see Instructions).
If you checked 30a, enter the loss on Form 1040, line 12, and Schedule SE, line 2 (statutory employees, see Instructions). If you checked 30b, you MUST attach Form 6198.

30a ☐ All investment is at risk.
30b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 Instructions. **Schedule C (Form 1040) 1990**

Schedule C (Form 1040) 1990 **Page 2**

Part III Cost of Goods Sold (See Instructions.)

31	Inventory at beginning of year. (If different from last year's closing inventory, attach explanation.)	31	42,843
32	Purchases less cost of items withdrawn for personal use	32	240,252
33	Cost of labor. (Do not include salary paid to yourself.)	33	-0-
34	Materials and supplies	34	-0-
35	Other costs	35	-0-
36	Add lines 31 through 35	36	283,095
37	Inventory at end of year	37	43,746
38	**Cost of goods sold.** Subtract line 37 from line 36. Enter the result here and on page 1, line 4	38	239,349

Part IV Principal Business or Professional Activity Codes

Locate the major category that best describes your activity. Within the major category, select the activity code that most closely identifies the business or profession that is the principal source of your sales or receipts. **Enter this 4-digit code on page 1, line B.** *For example, a grocery store is under the major category of "Retail Trade," and the code is "3210." (**Note:** If your principal source of income is from farming activities, you should file* **Schedule F** *(Form 1040), Farm Income and Expenses.)*

Construction

Code

0018 Operative builders (for own account)

General contractors

0034 Residential building
0059 Nonresidential building
0075 Highway and street construction
3889 Other heavy construction (pipe laying, bridge construction, etc.)

Building trade contractors, including repairs

0232 Plumbing, heating, air conditioning
0257 Painting and paper hanging
0273 Electrical work
0299 Masonry, dry wall, stone, tile
0414 Carpentering and flooring
0430 Roofing, siding, and sheet metal
0455 Concrete work
0885 Other building trade contractors (excavation, glazing, etc.)

Manufacturing, Including Printing and Publishing

0638 Food products and beverages
0653 Textile mill products
0679 Apparel and other textile products
0695 Leather, footware, handbags, etc.
0810 Furniture and fixtures
0836 Lumber and other wood products
0851 Printing and publishing
0877 Paper and allied products
1032 Stone, clay, and glass products
1057 Primary metal industries
1073 Fabricated metal products
1099 Machinery and machine shops
1115 Electric and electronic equipment
1883 Other manufacturing industries

Mining and Mineral Extraction

1511 Metal mining
1537 Coal mining
1552 Oil and gas
1719 Quarrying and nonmetallic mining

Agricultural Services, Forestry, Fishing

1933 Crop services
1958 Veterinary services, including pets
1974 Livestock breeding
1990 Other animal services
2113 Farm labor and management services
2212 Horticulture and landscaping
2238 Forestry, except logging
0836 Logging
2246 Commercial fishing
2469 Hunting and trapping

Wholesale Trade—Selling Goods to Other Businesses, Etc.

Durable goods, including machinery, equipment, wood, metals, etc.

2618 Selling for your own account
2634 Agent or broker for other firms—more than 50% of gross sales on commission

Nondurable goods, including food, fiber, chemicals, etc.

2659 Selling for your own account
2675 Agent or broker for other firms—more than 50% of gross sales on commission

Retail Trade—Selling Goods to Individuals and Households

3012 Selling door-to-door, by telephone or party plan, or from mobile unit
3038 Catalog or mail order
3053 Vending machine selling

Selling From Showroom, Store, or Other Fixed Location

Food, beverages, and drugs

3079 Eating places (meals or snacks)
3086 Catering services
3095 Drinking places (alcoholic beverages)
3210 Grocery stores (general line)
0612 Bakeries selling at retail
3236 Other food stores (meat, produce, candy, etc.)
3251 Liquor stores
3277 Drug stores

Automotive and service stations

3319 New car dealers (franchised)
3335 Used car dealers
3517 Other automotive dealers (motorcycles, recreational vehicles, etc.)
3533 Tires, accessories, and parts
3558 Gasoline service stations

General merchandise, apparel, and furniture

3715 Variety stores
3731 Other general merchandise stores
3756 Shoe stores
3772 Men's and boys' clothing stores
3913 Women's ready-to-wear stores
3921 Women's accessory and specialty stores and furriers
3939 Family clothing stores
3954 Other apparel and accessory stores
3970 Furniture stores
3996 TV, audio, and electronics
3988 Computer and software stores
4119 Household appliance stores
4317 Other home furnishing stores (china, floor coverings, etc.)
4333 Music and record stores

Building, hardware, and garden supply

4416 Building materials dealers
4432 Paint, glass, and wallpaper stores
4457 Hardware stores
4473 Nurseries and garden supply stores

Other retail stores

4614 Used merchandise and antique stores (except motor vehicle parts)
4630 Gift, novelty, and souvenir shops
4655 Florists
4671 Jewelry stores
4697 Sporting goods and bicycle shops
4812 Boat dealers
4838 Hobby, toy, and game shops
4853 Camera and photo supply stores
4879 Optical goods stores
4895 Luggage and leather goods stores
5017 Book stores, excluding newsstands
5033 Stationery stores
5058 Fabric and needlework stores
5074 Mobile home dealers
5090 Fuel dealers (except gasoline)
5884 Other retail stores

Finance, Insurance, Real Estate, and Related Services

5520 Real estate agents or brokers
5579 Real estate property managers
5710 Subdividers and developers, except cemeteries
5538 Operators and lessors of buildings, including residential
5553 Operators and lessors of other real property
5702 Insurance agents or brokers
5744 Other insurance services
6064 Security brokers and dealers
6080 Commodity contracts brokers and dealers, and security and commodity exchanges
6130 Investment advisors and services
6148 Credit institutions and mortgage bankers
6155 Title abstract offices
5777 Other finance and real estate

Transportation, Communications, Public Utilities, and Related Services

6114 Taxicabs
6312 Bus and limousine transportation
6361 Other highway passenger transportation
6338 Trucking (except trash collection)
6395 Courier or package delivery services
6510 Trash collection without own dump
6536 Public warehousing
6551 Water transportation
6619 Air transportation
6635 Travel agents and tour operators
6650 Other transportation services
6676 Communication services
6692 Utilities, including dumps, snowplowing, road cleaning, etc.

Services (Personal, Professional, and Business Services)

Hotels and other lodging places

7096 Hotels, motels, and tourist homes
7211 Rooming and boarding houses
7237 Camps and camping parks

Laundry and cleaning services

7419 Coin-operated laundries and dry cleaning
7435 Other laundry, dry cleaning, and garment services
7450 Carpet and upholstery cleaning
7476 Janitorial and related services (building, house, and window cleaning)

Business and/or personal services

7617 Legal services (or lawyer)
7633 Income tax preparation
7658 Accounting and bookkeeping
7518 Engineering services
7682 Architectural services
7708 Surveying services
7245 Management services
7260 Public relations
7286 Consulting services
7716 Advertising, except direct mail
7732 Employment agencies and personnel supply
7799 Consumer credit reporting and collection services
7856 Mailing, reproduction, commercial art and photography, and stenographic services
7872 Computer programming, processing, data preparation, and related services
7922 Computer repair, maintenance, and leasing
7773 Equipment rental and leasing (except computer or automotive)
7914 Investigative and protective services
7880 Other business services

Personal services

8110 Beauty shops (or beautician)
8318 Barber shop (or barber)
8334 Photographic portrait studios
8532 Funeral services and crematories
8714 Child day care
8730 Teaching or tutoring
8755 Counseling (except health practitioners)
8771 Ministers and chaplains
6882 Other personal services

Automotive services

8813 Automotive rental or leasing, without driver
8839 Parking, except valet
8953 Automotive repairs, general and specialized
8896 Other automotive services (wash, towing, etc.)

Miscellaneous repair, except computers

9019 TV and audio equipment repair
9035 Other electrical equipment repair
9050 Reupholstery and furniture repair
2881 Other equipment repair

Medical and health services

9217 Offices and clinics of medical doctors (MDs)
9233 Offices and clinics of dentists
9258 Osteopathic physicians and surgeons
9241 Podiatrists
9274 Chiropractors
9290 Optometrists
9415 Registered and practical nurses
9431 Other health practitioners
9456 Medical and dental laboratories
9472 Nursing and personal care facilities
9886 Other health services

Amusement and recreational services

8557 Physical fitness facilities
9597 Motion picture and video production
9688 Motion picture and tape distribution and allied services
9613 Videotape rental
9639 Motion picture theaters
9670 Bowling centers
9696 Professional sports and racing, including promoters and managers
9811 Theatrical performers, musicians, agents, producers, and related services
9837 Other amusement and recreational services

8888 Unable to classify

Form **4562**

Department of the Treasury
Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach this form to your return.

OMB No. 1545-0172
1990
Attachment Sequence No. 67

Name(s) shown on return: Susan J. Brown

Identifying number: 111-00-1111

Business or activity to which this form relates: Retail, ladies' apparel

Part I **Election To Expense Certain Tangible Property (Section 179)** (**Note:** *If you have any "Listed Property," also complete Part V.*)

1	Maximum dollar limitation (see instructions)	1	$10,000
2	Total cost of section 179 property placed in service during the tax year (see instructions)	2	7,500
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation—Subtract line 3 from line 2, but do not enter less than -0-	4	-0-
5	Dollar limitation for tax year—Subtract line 4 from line 1, but do not enter less than -0-	5	10,000

	(a) Description of property	(b) Cost	(c) Elected cost
6	5-Year Adding Machine	200	200
7	Listed property—Enter amount from line 26	7	

8	Total elected cost of section 179 property—Add amounts in column (c), lines 6 and 7	8	200
9	Tentative deduction—Enter the lesser of line 5 or line 8	9	200
10	Carryover of disallowed deduction from 1989 (see instructions)	10	
11	Taxable income limitation—Enter the lesser of taxable income or line 5 (see instructions)	11	10,000
12	Section 179 expense deduction—Add lines 9 and 10, but do not enter more than line 11	12	200
13	Carryover of disallowed deduction to 1991—Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for automobiles, certain other vehicles, cellular telephones, computers, or property used for entertainment, recreation, or amusement (listed property). Instead, use Part V for listed property.*

Part II **MACRS Depreciation For Assets Placed in Service ONLY During Your 1990 Tax Year (Do Not Include Listed Property)**

(a) Classification of property	(b) Mo. and yr. placed in service	(c) Basis for depreciation (Business use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
14 General Depreciation System (GDS) (see instructions):						
a 3-year property						
b 5-year property						
c 7-year property		800	7	HY	200 DB	114
d 10-year property						
e 15-year property						
f 20-year property						
g Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
h Nonresidential real property			31.5 yrs.	MM	S/L	
			31.5 yrs.	MM	S/L	
15 Alternative Depreciation System (ADS) (see instructions):						
a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part III **Other Depreciation (Do Not Include Listed Property)**

16	GDS and ADS deductions for assets placed in service in tax years beginning before 1990 (see instructions)	16	
17	Property subject to section 168(f)(1) election (see instructions)	17	
18	ACRS and other depreciation (see instructions)	18	1,117

Part IV **Summary**

19	Listed property—Enter amount from line 25	19	1,300
20	Total—Add deductions on line 12, lines 14 and 15 in column (g), and lines 16 through 19. Enter here and on the appropriate lines of your return. (Partnerships and S corporations—see instructions)	20	2,731
21	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs (see instructions)	21	

For Paperwork Reduction Act Notice, see page 1 of the separate instructions.

Form **4562** (1990)

Form 4562 (1990) Page 2

Part V Listed Property.—Automobiles, Certain Other Vehicles, Cellular Telephones, Computers, and Property Used for Entertainment, Recreation, or Amusement

If you are using the standard mileage rate or deducting vehicle lease expense, complete columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

Section A.—Depreciation (Caution: *See instructions for limitations for automobiles.*)

22a Do you have evidence to support the business use claimed? ☑ Yes ☐ No **22b** If "Yes," is the evidence written? ☑ Yes ☐ No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business use percentage	(d) Cost or other basis	(e) Basis for depreciation (business use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
23 *Property used more than 50% in a trade or business:*								
USA 280 S Van	3/20/90	75 %	8,667	6,500	5 Yrs	200DB HY	1,300	-0-
		%						
		%						
24 *Property used 50% or less in a trade or business:*								
		%				S/L-		▨
		%				S/L-		▨
		%				S/L-		▨
25 Add amounts in column (h). Enter the total here and on line 19, page 1						25	1,300	▨
26 Add amounts in column (i). Enter the total here and on line 7, page 1							26	

Section B.—Information Regarding Use of Vehicles—*If you deduct expenses for vehicles:*

- *Always complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person.*
- *If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.*

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
27 Total business miles driven during the year (DO NOT include commuting miles)	7,500											
28 Total commuting miles driven during the year	2,025											
29 Total other personal (noncommuting) miles driven	475											
30 Total miles driven during the year—Add lines 27 through 29	10,000											
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
31 Was the vehicle available for personal use during off-duty hours?	✓											
32 Was the vehicle used primarily by a more than 5% owner or related person?	✓											
33 Is another vehicle available for personal use?	✓											

Section C.—Questions for Employers Who Provide Vehicles for Use by Their Employees

(Answer these questions to determine if you meet an exception to completing Section B. **Note:** *Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.)*

	Yes	No
34 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
35 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
36 Do you treat all use of vehicles by employees as personal use?		
37 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
38 Do you meet the requirements concerning qualified automobile demonstration use (see instructions)?		
Note: *If your answer to 34, 35, 36, 37, or 38 is "Yes," you need not complete Section B for the covered vehicles.*	▨	▨

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
39 Amortization of costs that begins during your 1990 tax year:			▨	▨	▨
40 Amortization of costs that began before 1990				40	
41 Total. Enter here and on "Other Deductions" or "Other Expenses" line of your return				41	

SCHEDULE SE **(Form 1040)** Department of the Treasury Internal Revenue Service	**Social Security Self-Employment Tax** ▶ See Instructions for Schedule SE (Form 1040). ▶ Attach to Form 1040.	OMB No. 1545-0074 **1990** Attachment Sequence No. 17

Name of person with self-employment income (as shown on Form 1040) Susan J. Brown	Social security number of person with self-employment income ▶ 111 : 00 : 1111

Who Must File Schedule SE

You must file Schedule SE if:

- Your net earnings from self-employment were $400 or more; OR
- You were an employee of an electing church or church-controlled organization that paid you wages (church employee income) of $100 or more;

AND

- Your wages (subject to social security or railroad retirement tax) were less than $51,300.

Exception: If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner, AND you filed **Form 4361** and received IRS approval not to be taxed on those earnings, DO NOT file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 48.

For more information about Schedule SE, see the Instructions.

Note: *Most people can use the short Schedule SE on this page. But, you may have to use the longer Schedule SE on the back.*

Who MUST Use the Long Schedule SE (Section B)

You must use Section B if ANY of the following apply:

- You elect the "optional method" to figure your self-employment tax (see Section B, Part II, and the Instructions);
- You are a minister, member of a religious order, or Christian Science practitioner and you received IRS approval (from **Form 4361**) not to be taxed on your earnings from these sources, but you owe self-employment tax on other earnings;
- You had church employee income of $100 or more that was reported to you on Form W-2;
- You had tip income that is subject to social security tax, but you did not report those tips to your employer; OR
- You were a government employee with wages subject ONLY to the 1.45% Medicare part of the social security tax (Medicare qualified government wages) AND the total of **all** of your wages (subject to social security, railroad retirement, or the 1.45% Medicare tax) plus **all** your earnings subject to self-employment tax is **more** than $51,300.

Section A—Short Schedule SE (Read above to see if you must use the long Schedule SE on the back (Section B).)

1	Net farm profit or (loss) from Schedule F (Form 1040), line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1		
2	Net profit or (loss) from Schedule C (Form 1040), line 29, and Schedule K-1 (Form 1065), line 15a (other than farming). See Instructions for other income to report	2	52,713	
3	Combine lines 1 and 2. Enter the result	3	52,713	
4	Multiply line 3 by .9235. Enter the result. If the result is less than $400, **do not** file this schedule; you **do not** owe self-employment tax ▶	4	48,680	
5	Maximum amount of combined wages and self-employment earnings subject to social security or railroad retirement (tier 1) tax for 1990	5	$51,300	00
6	Total social security wages and tips (from Form(s) W-2) and railroad retirement compensation (tier 1). **Do not** include Medicare qualified government wages on this line	6		
7	Subtract line 6 from line 5. Enter the result. If the result is zero or less, **do not** file this schedule; you **do not** owe self-employment tax ▶	7	51,300	
8	Enter the **smaller** of line 4 or line 7	8	48,680	
9	Rate of tax	9	×.153	
10	**Self-employment tax.** If line 8 is $51,300, enter $7,848.90. Otherwise, multiply the amount on line 8 by the decimal amount on line 9 and enter the result. Also enter this amount on Form 1040, line 48 **Note:** *Also enter one-half of this amount on Form 1040, line 25.*	10	7,448	

For Paperwork Reduction Act Notice, see Form 1040 Instructions. **Schedule SE (Form 1040) 1990**

38. Form 1065—Partnership

The filled-in Form 1065 is for the AbleBee Book Store, a partnership composed of Frank Able and William Brown. The partnership uses the accrual method of accounting and a calendar year for reporting income and loss. Mr. Able works full time in the business, while Mr. Brown works approximately 25% of his time in it. Both partners are general partners. The partnership agreement states that Mr. Able will receive a yearly guaranteed payment of $20,000, and Mr. Brown will receive $5,000. Any profit or loss will be shared equally by the partners. The partners are personally liable for all partnership liabilities. Both partners materially participate in the operation of the business.

Note that each partner's distributive share of specially allocated items should be shown on the appropriate line of the applicable partner's Schedule K-1, and the total amount on Schedule K instead of on page 1, Form 1065.

Page 1

The pre-addressed label from the cover of the Form 1065 package that the partnership received in the mail is placed in the address area of the form. (However, a partnership should wait to do this until after completing the return, in case a mistake is made and the return has to be redone.) Make any necessary corrections on the label. If a partnership does not receive a Form 1065 package in the mail and does not have a pre-addressed label, the partnership should enter its name and address in this area. All the information asked for at the top of page 1, Form 1065, is supplied in this example.

Income

The partnership's ordinary income (loss) is shown on lines 1a through 8.

Line 1. Gross sales of $409,465 are entered on line 1a. Returns and allowances of $3,365 are entered on line 1b, resulting in net sales of $406,100, entered on line 1c.

Line 2. Cost of goods sold, $267,641, from Schedule A, line 7 (discussed later), is entered here.

Line 3. Gross profit of $138,459 is shown on this line.

Line 7. Interest income on accounts receivable, $559, is entered on this line. The schedule that must be attached for this line is not shown.

Line 8. Total income, $139,018 (lines 3 through 7), is shown on line 8.

Deductions

The partnership's allowable deductions are shown next on lines 9 through 20.

Line 9. All salaries and wages are included on line 9a, ***except*** guaranteed payments to partners (shown on line 10). The AbleBee Book Store lists $29,350 on lines 9a and 9c. Because the partnership was not eligible for the jobs credit, no entry is made on line 9b. See Form 5884 for more information on the jobs credit.

Line 10. Guaranteed payments of $25,000 to partners Able ($20,000) and Brown ($5,000) are entered here. If a guaranteed payment is for interest paid to a partner, enter it here and not on line 12.

Line 11. Rent paid for the business premises, $20,000, is listed on this line.

Line 12. Interest paid to suppliers during the year totaled $1,451. This is business interest, so it is entered on line 12. Interest paid to a ***partner*** that is not a guaranteed payment is included on this line. See Chapter 16 for more information on interest.

Line 13. Deductible taxes of $3,295 are entered on this line. See Chapter 18 for more information.

Line 14. During the year, $250 of amounts owed to the partnership was determined to be worthless. This amount is shown on line 14. If debts previously written off and deducted are collected in later years, the amount collected generally must be included in partnership gross income for the year in which the amount is collected. See Chapter 14 for more information.

Line 15. Repairs of $1,125 made to equipment owned by the partnership are entered on this line. To qualify for the deduction, repairs must not add to the value or appreciably prolong the life of the property repaired.

Lines 16a and 16c. Depreciation of $1,174 from Form 4562, *Depreciation and Amortization,* is entered here. Any amount on line 16b is also from Form 4562. The partnership must use Form 4562 to report the depreciation expense claimed on this line and elsewhere on the partnership return. A filled-in Form 4562 is not shown in this example.

Line 19. Other allowable deductions of $8,003 that are not claimed elsewhere on the return or for which a separate line is not provided on page 1 are included on this line. The partnership attaches a schedule that lists each deduction included on line 19. This schedule is not illustrated.

Line 20. Total deductions, $89,648 (lines 9c through 19), are entered on this line.

Line 21. The amount on line 20 is subtracted from the amount on line 8. The result, $49,370, is entered on line 21 of page 1 and is allocated to each partner on line 1 of Schedule K-1. The total is shown on line 1 of Schedule K.

Signatures

The return must be signed by a general partner. Also, any person, firm, or corporation that prepares the return for compensation, other than a full-time employee of the partnership, must sign it. The AbleBee Book Store did not have a paid preparer who was required to sign the return.

Page 2
Schedule A

Schedule A is the computation of cost of goods sold. Beginning inventory, $18,125 (entered on line 1), is added to net purchases, $268,741, entered on line 2, and the total, $286,866, is entered on line 5. Ending inventory, $19,225 (entered on line 6), is subtracted from the amount on line 5 to arrive at cost of goods sold, $267,641 (entered on line 7 and on page 1, line 2).

The partnership answered all applicable questions for item 8.

Schedules L and M

Partnerships do not have to complete Schedule L or Schedule M if all of the tests listed in the instructions for Form 1065 are met and Question N is marked "Yes."

The AbleBee Book Store does not meet all of the tests, so Schedules L and M must be completed.

Schedule L. Schedule L contains the partnership's balance sheets at the beginning and end of the tax year. All information shown on the balance sheets for the AbleBee Book Store should agree with its books of account. Any differences should be reconciled and explained in a separate schedule attached to the return. The entry for total assets at the end of the year, $45,391, is carried to Item F at the top of page 1 if Item F is required to be completed. See the instructions for Form 1065 for more information.

Schedule M. Schedule M shows the total equity of all partners in the partnership at the beginning and end of the tax year and shows the adjustments that caused any increase or decrease. The total of all the partners' capital accounts is the difference between the partnership's assets and liabilities shown on Schedule L. A partner's capital account will not necessarily represent the tax basis for an interest in the partnership. The letters used below refer to columns in the schedule.

- Column a. As of January 1, the total of the partners' capital accounts was $27,550 (Mr. Able—$14,050; Mr. Brown—$13,500). This amount should agree with the beginning balance shown on Schedule L for the partners' capital accounts.
- Column c. This is the income from Schedule K, Form 1065, page 3, lines 1, 2, 3c, and 4. (The guaranteed payments to the partners are not included in this column because they were deducted to arrive at the amount shown on line 21, page 1, Form 1065.)
- Column d. Included in column (d) is income reported in the partnership's books but not included in column (c), such as tax-exempt income and deductions used to figure the amount shown in column (c) but not charged against book income this year. Included here is $50 of tax-exempt interest on municipal bonds.
- Column e. The partnership made a $650 charitable contribution that is not allowable as a deduction to the partnership on page 1, Form 1065. However, since it was cash paid out, it decreases the partners' equity.
- Column f. Each partner withdrew $26,440 (totaling $52,880) from the partnership. The partners' guaranteed payments, which were actually paid, are not included in this column because they were deducted in arriving at the amount shown in column (c). Any other distributions to the partners, in cash or property other than cash, would also be included here.
- Column g. This shows the total equity of all partners as shown in the books of account as of December 31. This amount should agree with the ending balance shown on Schedule L for the partners' capital accounts.

Item K on Schedule K-1 reflects each partner's share of the amounts shown in columns (a) through (g) of Schedule M.

Page 3
Schedule K (and Schedule K–1)

Schedule K must be completed by all partnerships.

Schedule K. Schedule K lists the total of the partners' shares of income, deductions, credits, etc. The partnership agreement can provide for the manner in which the partners will share each item of income, gain, loss, deduction, or credit, etc., of the partnership. If the main purpose of any provision in the partnership agreement, regarding a partner's share of any item, is to evade or avoid federal income tax, the provision will be disregarded.

Each partner is allocated his or her distributive share of any item from the partnership if a different income tax liability will result from the item being distributable to the partner separately, rather than being distributable to the partner as part of the partnership's income or loss (line 21, page 1). Each partner's distributive share of income, deductions, credits, etc., should be reported on Schedule K–1.

Schedule K–1. Schedule K–1 lists each partner's share of income, deductions, credits, etc. It also indicates where to report the items on the partner's return. Illustrated is a copy of the Schedule K–1 for Frank W. Able. All information asked for at the top of Schedule K–1 must be supplied for each partner. The *Reconciliation of partner's capital account* (Item K) must be completed, unless Question N, page 1, Form 1065, is marked "Yes."

Since all line items on Schedule K–1 are not applicable to every partnership, a substitute Schedule K–1 may be used. See the instructions for Form 1065 for more information.

Allocation of Partnership Items

The partners' shares of income, deductions, etc., are shown next in lines 1 through 20b, Schedule K, and lines 1 through 21, Schedule K–1.

Income (Loss)

Line 1. This line on Schedule K–1 shows Able's share, $24,685, of the net income from the partnership shown on line 21, page 1. The total amount of net income is shown on line 1, Schedule K.

Line 4b. Dividends are among the items that must be separately stated and not included in the income (loss) of the partnership on Form 1065, page 1, line 21. This line on Schedule K–1 shows Able's share, $75. This line on Schedule K shows the total dividends of $150.

Line 5. This line on Schedule K–1 shows guaranteed payments to Able of $20,000. This line on Schedule K shows the total guaranteed payments, $25,000.

Deductions

Line 8. During the year, the partnership made a $650 contribution to the American Lung Association. Each partner can deduct all or part of his or her share of the partnership's charitable contributions on his or her tax return, if the partner itemizes deductions. For more information, see Publication 526, *Charitable Contributions.*

Investment interest

Lines 12a–12b. The total of the partnership's interest on investment debt, and items of investment income and expenses, are entered on the applicable lines of Schedule K, and each partner's share is entered on Schedule K–1. For more information, see Publication 550, *Investment Income and Expenses,* and the instructions for Form 1065. This partnership did not have any investment interest expense or other investment expenses. It did have investment income as shown on line 4b. The total is shown on line 12b(1), Schedule K, and the partner's share on line 12b(1), Schedule K–1.

Self-employment tax

Line 15a. Net earnings (loss) from self-employment are entered on Schedule K, and each individual partner's share is shown on his or her Schedule K–1. Guaranteed payments are included in net earnings from self-employment. Each partner uses his or her share to figure his or her self-employment tax on Schedule SE (Form 1040), *Social Security Self-Employment Tax.*

Analysis

Lines 20a–20b (Schedule K only). An analysis must be made of the distributive items on lines 1 through 7, Schedule K. This analysis is based on type of partner. Since the AbleBee Book Store has two persons, both of whom are general partners, the entries are $74,520 on lines 20a and 20b(1), column (b)i, the total of lines 1 through 7.

Form **1065**
Department of the Treasury
Internal Revenue Service

U.S. Partnership Return of Income

For calendar year 1990, or tax year beginning ...., 1990, and ending ...., 19 ....

▶ See separate instructions.

OMB No 1545-0099

1990

A Principal business activity: Retail

B Principal product or service: Books

C Business code number: 5942

Use IRS label. Otherwise, please print or type.

10-9876543 DEC90 D71
AbleBee Book Store
334 WEST MAIN STREET
ANYTOWN MD 20904

IRS

D Employer identification number

E Date business started: 10/1/78

F Total assets (see Specific Instructions): $ 45,391

G Check applicable boxes (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return

H Check accounting method (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) ▶ ....

		Yes	No
I	Number of partners in this partnership ▶ 2		
J	Is this partnership a limited partnership?		✓
K	Are any partners in this partnership also partnerships?		✓
L	Is this partnership a partner in another partnership?		✓
M	Is this partnership subject to the consolidated audit procedures of sections 6221 through 6233? If "Yes," see "Designation of Tax Matters Partner" on page 2		✓
N	Does this partnership meet **all** the requirements shown in the instructions for **Question N**?		✓
O	Does this partnership have any foreign partners?		✓
P	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		✓
Q	Has this partnership filed, or is it required to file, Form **8264**, Application for Registration of a Tax Shelter?		✓
R	Was there a distribution of property or a transfer (for example, by sale or death) of a partnership interest during the tax year? If "Yes," see the instructions concerning an election to adjust the basis of the partnership's assets under section 754		✓
S	At any time during the tax year, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See the instructions for exceptions and filing requirements for form TD F 90-22.1.) If "Yes," enter the name of the foreign country ▶		✓
T	Was the partnership the grantor of, or transferor to, a foreign trust which existed during the current tax year, whether or not the partnership or any partner has any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		✓

Caution: *Include **only** trade or business income and expenses on lines 1a through 21 below. See the instructions for more information.*

Income	**1a** Gross receipts or sales	1a	409,465		
	b Less returns and allowances	1b	3,365	1c	406,100
	2 Cost of goods sold (Schedule A, line 7)			2	267,641
	3 Gross profit—Subtract line 2 from line 1c			3	138,459
	4 Ordinary income (loss) from other partnerships and fiduciaries *(attach schedule)*			4	
	5 Net farm profit (loss) *(attach Schedule F (Form 1040))*			5	
	6 Net gain (loss) from Form 4797, Part II, line 18			6	
	7 Other income (loss) (see instructions) *(attach schedule)*			7	559
	8 **Total** income (loss)—Combine lines 3 through 7			8	139,018
Deductions (see instructions for limitations)	**9a** Salaries and wages (other than to partners)	9a	29,350		
	b Less jobs credit	9b	–	9c	29,350
	10 Guaranteed payments to partners			10	25,000
	11 Rent			11	20,000
	12 Interest			12	1,451
	13 Taxes			13	3,295
	14 Bad debts			14	250
	15 Repairs			15	1,125
	16a Depreciation (see instructions)	16a	1,174		
	b Less depreciation reported on Schedule A and elsewhere on return	16b	–	16c	1,174
	17 Depletion **(Do not deduct oil and gas depletion.)**			17	
	18a Retirement plans, etc.			18a	
	b Employee benefit programs			18b	
	19 Other deductions *(attach schedule)*			19	8,003
	20 **Total** deductions—Add lines 9c through 19			20	89,648
	21 Ordinary income (loss) from trade or business activities—Subtract line 20 from line 8			21	49,370

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner) is based on all information of which preparer has any knowledge.

▶ Frank W. Able ▶ 3/27/91
Signature of general partner Date

Paid Preparer's Use Only

Preparer's signature ▶ Date Check if self-employed ▶ ☐ Preparer's social security no.

Firm's name (or yours if self-employed) and address ▶ E.I. No. ▶ ZIP code ▶

For Paperwork Reduction Act Notice, see page 1 of separate instructions.

Form **1065** (1990)

Schedule A Cost of Goods Sold

1	Inventory at beginning of year	1	18,125
2	Purchases less cost of items withdrawn for personal use	2	268,741
3	Cost of labor	3	–
4a	Additional section 263A costs (see instructions) *(attach schedule)*	4a	–
b	Other costs *(attach schedule)*	4b	
5	Total—Add lines 1 through 4b	5	286,866
6	Inventory at end of year	6	19,225
7	Cost of goods sold—Subtract line 6 from line 5. Enter here and on page 1, line 2	7	267,641

8a Check all methods used for valuing closing inventory:

(i) ☐ Cost (ii) ☑ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c)

(iv) ☐ Other (specify method used and attach explanation) ▶ ....

b Check this box if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

c Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the partnership? ☐ Yes ☑ No

d Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation. ☐ Yes ☑ No

Schedule L Balance Sheets

Caution: *Read the instructions for **Question N** on page 9 of the instructions before completing Schedules L and M.*

	Beginning of tax year		End of tax year	
Assets	(a)	(b)	(c)	(d)
1 Cash		3,455		3,350
2a Trade notes and accounts receivable	7,150		10,990	
b Less allowance for bad debts		7,150		10,990
3 Inventories		18,125		19,225
4 U.S. government obligations				
5 Tax-exempt securities		1,000		1,000
6 Other current assets *(attach schedule)*				
7 Mortgage and real estate loans				
8 Other investments *(attach schedule)*		1,000		1,000
9a Buildings and other depreciable assets	15,000		15,000	
b Less accumulated depreciation	4,000	11,000	5,174	9,826
10a Depletable assets				
b Less accumulated depletion				
11 Land (net of any amortization)				
12a Intangible assets (amortizable only)				
b Less accumulated amortization				
13 Other assets *(attach schedule)*				
14 **Total** assets		41,730		45,391
Liabilities and Capital				
15 Accounts payable		10,180		10,462
16 Mortgages, notes, bonds payable in less than 1 year		4,000		3,600
17 Other current liabilities *(attach schedule)*				
18 All nonrecourse loans				
19 Mortgages, notes, bonds payable in 1 year or more		–		7,739
20 Other liabilities *(attach schedule)*				
21 Partners' capital accounts		27,550		23,590
22 **Total** liabilities and capital		41,730		45,391

Schedule M Reconciliation of Partners' Capital Accounts

(Show reconciliation of each partner's capital account on Schedule K-1 (Form 1065), Item K.)

(a) Partners' capital accounts at beginning of year	(b) Capital contributed during year	(c) Income (loss) from lines 1, 2, 3c, and 4 of Schedule K	(d) Income not included in column (c), plus nontaxable income	(e) Losses not included in column (c), plus unallowable deductions	(f) Withdrawals and distributions	(g) Partners' capital accounts at end of year (combine columns (a) through (f))
27,550	–	49,520	50	(650)	(52,880)	23,590

Designation of Tax Matters Partner (See instructions.)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

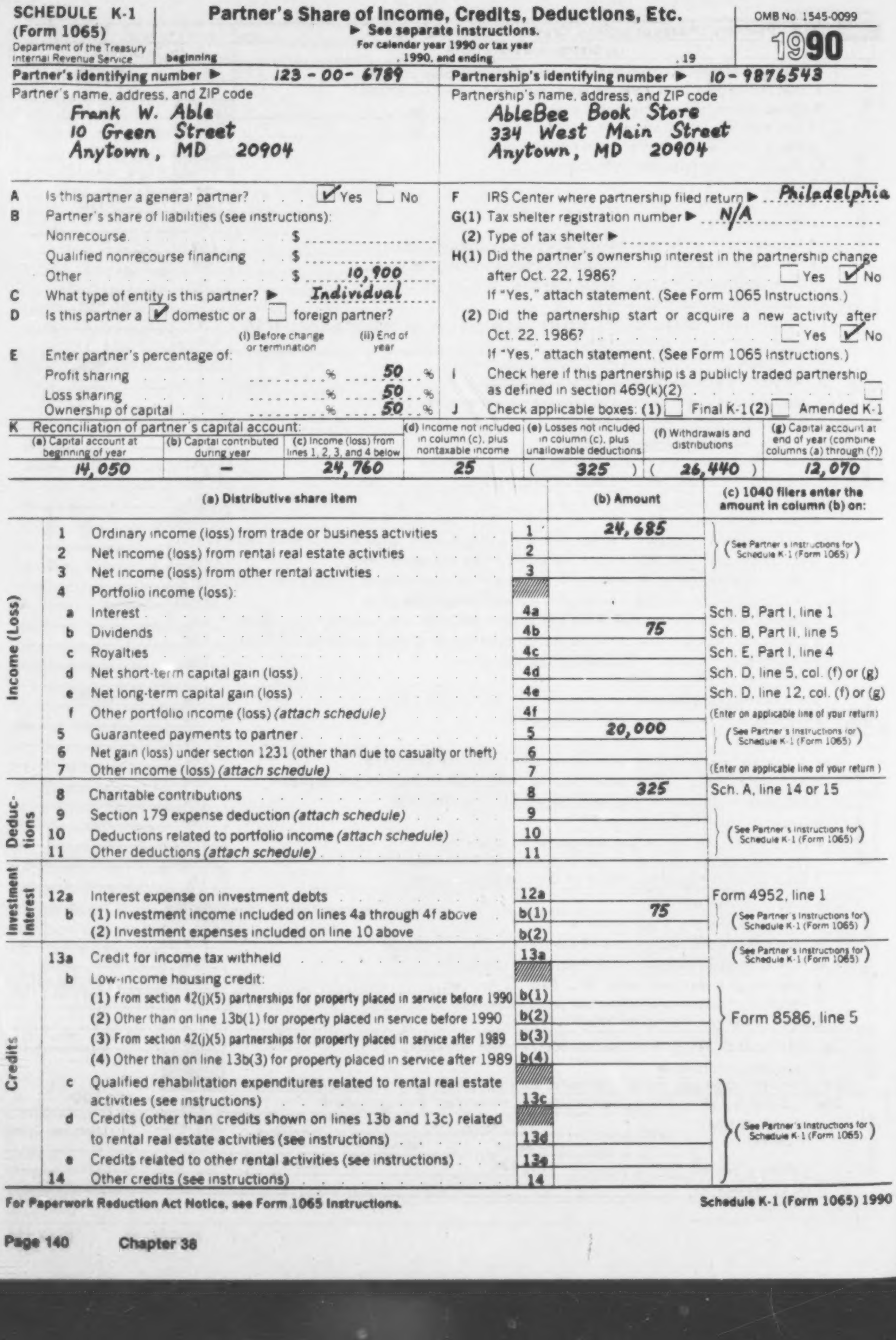
Name of designated TMP ▶ Identifying number of TMP ▶

Address of designated TMP ▶

Schedule K Partners' Shares of Income, Credits, Deductions, Etc.

	(a) Distributive share items			(b) Total amount
Income (Loss)	1 Ordinary income (loss) from trade or business activities (page 1, line 21)		1	49,370
	2 Net income (loss) from rental real estate activities *(attach Form 8825)*		2	
	3a Gross income from other rental activities	3a	▨	
	b Less expenses *(attach schedule)*	3b	▨	
	c Net income (loss) from other rental activities		3c	
	4 Portfolio income (loss) (see instructions):		▨	
	a Interest income		4a	
	b Dividend income		4b	150
	c Royalty income		4c	
	d Net short-term capital gain (loss) *(attach Schedule D (Form 1065))*		4d	
	e Net long-term capital gain (loss) *(attach Schedule D (Form 1065))*		4e	
	f Other portfolio income (loss) *(attach schedule)*		4f	
	5 Guaranteed payments to partners		5	25,000
	6 Net gain (loss) under section 1231 (other than due to casualty or theft) *(attach Form 4797)*		6	
	7 Other income (loss) *(attach schedule)*		7	
Deductions	8 Charitable contributions (see instructions) *(attach list)*		8	650
	9 Section 179 expense deduction *(attach Form 4562)*		9	
	10 Deductions related to portfolio income (see instructions) (itemize)		10	
	11 Other deductions *(attach schedule)*		11	
Investment Interest	12a Interest expense on investment debts		12a	
	b (1) Investment income included on lines 4a through 4f above		12b(1)	150
	(2) Investment expenses included on line 10 above		12b(2)	
Credits	13a Credit for income tax withheld		13a	
	b Low-income housing credit (see instructions):		▨	
	(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990		13b(1)	
	(2) Other than on line 13b(1) for property placed in service before 1990		13b(2)	
	(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989		13b(3)	
	(4) Other than on line 13b(3) for property placed in service after 1989		13b(4)	
	c Qualified rehabilitation expenditures related to rental real estate activities *(attach Form 3468)*		13c	
	d Credits (other than credits shown on lines 13b and 13c) related to rental real estate activities (see instructions)		13d	
	e Credits related to other rental activities (see instructions)		13e	
	14 Other credits (see instructions)		14	
Self-Employment	15a Net earnings (loss) from self-employment		15a	74,370
	b Gross farming or fishing income		15b	
	c Gross nonfarm income		15c	
Adjustments and Tax Preference Items	16a Accelerated depreciation of real property placed in service before 1987		16a	
	b Accelerated depreciation of leased personal property placed in service before 1987		16b	
	c Depreciation adjustment on property placed in service after 1986		16c	
	d Depletion (other than oil and gas)		16d	
	e (1) Gross income from oil, gas, and geothermal properties		16e(1)	
	(2) Deductions allocable to oil, gas, and geothermal properties		16e(2)	
	f Other adjustments and tax preference items *(attach schedule)*		16f	
Foreign Taxes	17a Type of income ▶		▨	
	b Foreign country or U.S. possession ▶		▨	
	c Total gross income from sources outside the U.S. *(attach schedule)*		17c	
	d Total applicable deductions and losses *(attach schedule)*		17d	
	e Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued		17e	
	f Reduction in taxes available for credit *(attach schedule)*		17f	
	g Other foreign tax information *(attach schedule)*		17g	
Other	18a Total expenditures to which a section 59(e) election may apply		18a	
	b Type of expenditures ▶		▨	
	19 Other items and amounts required to be reported separately to partners (see instructions) *(attach schedule)*		▨	
Analysis	20a Total distributive income/payment items—Combine lines 1 through 7 above		20a	74,520

b Analysis by type of partner:	(a) Corporate	(b) Individual		(c) Partnership	(d) Exempt organization	(e) Nominee/Other
		i Active	ii Passive			
(1) General partners		74,520				
(2) Limited partners						



SCHEDULE K-1
(Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Credits, Deductions, Etc.

▶ **See separate instructions.**
For calendar year 1990 or tax year
beginning , 1990, and ending , 19

OMB No. 1545-0099
1990

Partner's identifying number ▶ 123 - 00- 6789
Partnership's identifying number ▶ 10 - 9876543

Partner's name, address, and ZIP code
Frank W. Able
10 Green Street
Anytown, MD 20904

Partnership's name, address, and ZIP code
AbleBee Book Store
334 West Main Street
Anytown, MD 20904

A Is this partner a general partner? ☑ Yes ☐ No
B Partner's share of liabilities (see instructions):
Nonrecourse $
Qualified nonrecourse financing $
Other $ 10,900
C What type of entity is this partner? ▶ Individual
D Is this partner a ☑ domestic or a ☐ foreign partner?
E Enter partner's percentage of:

	(i) Before change or termination	(ii) End of year
Profit sharing	%	50 %
Loss sharing	%	50 %
Ownership of capital	%	50 %

F IRS Center where partnership filed return ▶ Philadelphia
G(1) Tax shelter registration number ▶ N/A
(2) Type of tax shelter ▶
H(1) Did the partner's ownership interest in the partnership change after Oct. 22, 1986? ☐ Yes ☑ No
If "Yes," attach statement. (See Form 1065 Instructions.)
(2) Did the partnership start or acquire a new activity after Oct. 22, 1986? ☐ Yes ☑ No
If "Yes," attach statement. (See Form 1065 Instructions.)
I Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) ☐
J Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

K Reconciliation of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Income (loss) from lines 1, 2, 3, and 4 below	(d) Income not included in column (c), plus nontaxable income	(e) Losses not included in column (c), plus unallowable deductions	(f) Withdrawals and distributions	(g) Capital account at end of year (combine columns (a) through (f))
14,050	–	24,760	25	(325)	(26,440)	12,070

		(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1	24,685	(See Partner's Instructions for Schedule K-1 (Form 1065))
	2	Net income (loss) from rental real estate activities	2		
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss):	▨		
	a	Interest	4a		Sch. B, Part I, line 1
	b	Dividends	4b	75	Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f) or (g)
	e	Net long-term capital gain (loss)	4e		Sch. D, line 12, col. (f) or (g)
	f	Other portfolio income (loss) *(attach schedule)*	4f		(Enter on applicable line of your return)
	5	Guaranteed payments to partner	5	20,000	(See Partner's Instructions for Schedule K-1 (Form 1065))
	6	Net gain (loss) under section 1231 (other than due to casualty or theft)	6		
	7	Other income (loss) *(attach schedule)*	7		(Enter on applicable line of your return)
Deductions	8	Charitable contributions	8	325	Sch. A, line 14 or 15
	9	Section 179 expense deduction *(attach schedule)*	9		(See Partner's Instructions for Schedule K-1 (Form 1065))
	10	Deductions related to portfolio income *(attach schedule)*	10		
	11	Other deductions *(attach schedule)*	11		
Investment Interest	12a	Interest expense on investment debts	12a		Form 4952, line 1
	b	(1) Investment income included on lines 4a through 4f above	b(1)	75	(See Partner's Instructions for Schedule K-1 (Form 1065))
		(2) Investment expenses included on line 10 above	b(2)		
Credits	13a	Credit for income tax withheld	13a		(See Partner's Instructions for Schedule K-1 (Form 1065))
	b	Low-income housing credit:	▨		
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
		(2) Other than on line 13b(1) for property placed in service before 1990	b(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
		(4) Other than on line 13b(3) for property placed in service after 1989	b(4)		
	c	Qualified rehabilitation expenditures related to rental real estate activities (see instructions)	13c		(See Partner's Instructions for Schedule K-1 (Form 1065))
	d	Credits (other than credits shown on lines 13b and 13c) related to rental real estate activities (see instructions)	13d		
	e	Credits related to other rental activities (see instructions)	13e		
	14	Other credits (see instructions)	14		

For Paperwork Reduction Act Notice, see Form 1065 Instructions.

Schedule K-1 (Form 1065) 1990

		(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Self-employment	15a	Net earnings (loss) from self-employment	15a	44,685	Sch. SE, Section A or B
	b	Gross farming or fishing income	15b		(See Partner's Instructions for Schedule K-1 (Form 1065))
	c	Gross nonfarm income	15c		
Adjustments and Tax Preference Items	16a	Accelerated depreciation of real property placed in service before 1987	16a		(See Partner's Instructions for Schedule K-1 (Form 1065) and Form 6251 Instructions)
	b	Accelerated depreciation of leased personal property placed in service before 1987	16b		
	c	Depreciation adjustment on property placed in service after 1986	16c		
	d	Depletion (other than oil and gas)	16d		
	e	(1) Gross income from oil, gas, and geothermal properties	e(1)		
		(2) Deductions allocable to oil, gas, and geothermal properties	e(2)		
	f	Other adjustments and tax preference items *(attach schedule)*	16f		
Foreign Taxes	17a	Type of income ▶			Form 1116, Check boxes
	b	Name of foreign country or U.S. possession ▶			Form 1116, Part I
	c	Total gross income from sources outside the U.S. *(attach schedule)*	17c		Form 1116, Part I
	d	Total applicable deductions and losses *(attach schedule)*	17d		Form 1116, Part I
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	17e		Form 1116, Part II
	f	Reduction in taxes available for credit *(attach schedule)*	17f		Form 1116, Part III
	g	Other foreign tax information *(attach schedule)*	17g		See Form 1116 Instructions
Other	18a	Total expenditures to which a section 59(e) election may apply	18a		(See Partner's Instructions for Schedule K-1 (Form 1065))
	b	Type of expenditures ▶			
Recapture of Tax Credits	19	Recapture of low-income housing credit:			
	a	From section 42(j)(5) partnerships	19a		Form 8611, line 8
	b	Other than on line 19a	19b		

		A	B	C	
20	Investment credit properties:				
a	Description of property (State whether recovery or nonrecovery property. If recovery property, state whether regular percentage method or section 48(q) election used.)				Form 4255, top
b	Date placed in service				Form 4255, line 2
c	Cost or other basis				Form 4255, line 3
d	Class of recovery property or original estimated useful life				Form 4255, line 4
e	Date item ceased to be investment credit property				Form 4255, line 8

Supplemental Information

21 Supplemental information required to be reported separately to each partner *(attach additional schedules if more space is needed)*:

39. Form 1120–A Corporation (Short-Form)

Rose Flower Shop, Inc., is the corporation for which the sample return is filled out. Rose Flower Shop is engaged in the business of selling fresh cut flowers and plants. It uses an accrual method of accounting and files its returns on the calendar year.

A corporation may file Form 1120–A if it has gross receipts under $500,000, total income under $500,000, total assets under $500,000, and meets certain other requirements. Since Rose Flower Shop met all these requirements for 1990, it filed Form 1120–A.

Page 1

If possible when you prepare your return, you should use the pre-addressed label sent to you by the IRS. The pre-addressed label is designed to expedite processing and prevent errors. If you do not have a corporation tax form with a pre-addressed label, enter your corporation's name, street address, city, state, and ZIP code in the appropriate spaces on the first page. After entering the identifying information called for at the top of the page, Rose Flower Shop proceeds to report its items of income and deductions.

The name and employer identification number of the corporation should also be shown in the top margin of schedules and attachments to Form 1120–A.

Fill in applicable lines. All applicable items for gross income, deductions, and tax listed on page 1 of Form 1120–A should be filled in even though totals must be shown on the printed forms. Do not alter, substitute for, or cross out the line captions on the return forms.

Line 1. Gross sales for the year totaled $248,000, using the accrual basis of accounting. After subtracting $7,500 of returned goods and allowances, net sales of $240,500 is entered on line 1c.

Line 2. Cost of goods sold is deducted on line 2. This figure, $144,000, is computed by using the worksheet (not illustrated) provided in the form instructions.

Line 3. Net sales less cost of goods sold results in gross profit of $96,500.

Lines 4 through 10. Other items of income are shown next. During the year, the only other item of income was taxable interest of $942, shown on line 5.

Line 11. Total income amounts to $97,442.

Line 12. The salary of the company president was $23,000 and is entered on line 12.

Line 13. Other salaries and wages total $24,320 and are deducted on line 13a. This includes only salaries and wages not included on line 12, and not deducted as part of cost of goods sold on line 2. Rose Flower Shop was not entitled to a jobs credit, so $24,320 is also entered on line 13c.

Line 16. Rental expense for Rose Flower Shop's store was $6,000 for the year.

Line 17. Deductible taxes totaled $3,320.

Line 18. Interest expense accrued during the year amounted to $1,340. Interest to carry tax-exempt securities is not included. See Publication 535, *Business Expenses,* for a discussion of amounts deductible as interest as well as when the deduction may be taken.

Line 19. During 1990, Rose Flower Shop contributed $1,820 to various charitable organizations. The total of $1,820 is less than the limit for deductible contributions, which is 10% of taxable income figured without regard to the contribution deduction.

Line 22. Other deductions consist of $3,000 in advertising expense. If there had been several expenses included in the total, a supporting schedule would be required.

Line 23. Total deductions amount to $62,800.

Lines 24, 25, and 26. Taxable income, $34,642, is shown on line 24. Since Rose Flower Shop did not have a net operating loss or special deduction, $34,642 is also entered on line 26.

Tax summary. Enter on line 27 the total tax ($5,196) from Part I, line 7, on page 2. Payments against the tax are listed on line 28. On the Rose Flower Shop return, the only payment is the four estimated tax payments totaling $6,000. It is entered on line 28b, line 28d, and as a total on line 28h. The resulting overpayment is $804, which Rose Flower Shop chooses to have credited to its 1991 estimated tax. Rose Flower Shop could have had the overpayment refunded if it wanted to.

Signature. Rose Flower Shop's return must be signed manually by the corporate officer authorized to sign it.

Page 2

Part I—Tax Computation. The tax computation schedule in the form instructions is used to figure the tax on line 1. Lines 3, 5, and 6, the other taxes and credits listed on Part I, do not apply to Rose Flower Shop. The tax of $5,196 is entered on lines 1, 4, and 7.

Additional information. On page 2, all applicable questions must be answered. The business activity code number, business activity, and product or service information must be provided on lines (1), (2), and (3) of question G. Purchases of $134,014 appear on line (1)(a) of question J. Other costs of $9,466 appear on line (1)(c) of question J. The supporting itemization is not illustrated, but these costs consist basically of costs directly related to the sale of flowers, wreaths, and plants, such as flower pots, vases, stands, boxes, wire strands, and tissue paper.

Part II—Balance Sheets. Comparative balance sheets for the beginning and end of the tax year must be provided in Part II. Entries in Part II should agree with amounts shown elsewhere on the return or included on a worksheet. For example, the figures for beginning and ending inventories must be the same as those appearing on the worksheet in the form instructions for cost of goods sold.

Part III—Reconciliation of Income per Books With Income per Return. All Form 1120–A corporate filers must complete Part III. This is so even though Form 1120 corporate filers are not required to complete Schedule M–1, *Reconciliation of Income per Books With Income per Return,* if their total assets are less than $25,000.

To properly complete Part III, first get additional information from your corporation's books and records. The following profit and loss account appeared in the books of Rose Flower Shop for the calendar year 1990.

Account	Debit	Credit
Gross sales		$248,000
Sales returns and allowances	$ 7,500	
Cost of goods sold	144,000	
Interest income		942
Compensation of officers	23,000	
Salaries and wages	24,320	
Rents	6,000	
Taxes	3,320	
Interest expense	1,340	
Contributions	1,820	
Advertising	3,000	
Federal income tax accrued	5,196	
Net income for books after tax	29,446	
Total	$248,942	$248,942

Part III starts with the net income per books, after reduction for federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 24, page 1.

Line 1. This is the net income per books, $29,446, shown in the profit and loss account previously as net income per books after tax.

Line 2. This is the federal income tax accrued for the year of the return, $5,196.

Line 7. The taxable income, $34,642, is shown on line 24, page 1 (Taxable income) before net operating loss deduction and special deductions.

Form **1120-A**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Short-Form Income Tax Return

Instructions are separate. See them to make sure you qualify to file Form 1120-A.
For calendar year 1990 or tax year beginning ...., 1990, ending ...., 19 .....

OMB No. 1545-0890
1990

A Check this box if corp. is a personal service corp. (as defined in Temp. Regs. sec. 1.441-4T—see instructions) ▶ ☐

Use IRS label. Otherwise, please print or type.

10-2134567 DEC90 D90 5995
ROSE FLOWER SHOP, INC.
38 SUPERIOR LANE
FAIR CITY, MD 20715

B Employer identification number
C Date incorporated 7-1-82
D Total assets (see Specific Instructions) $ 65,987

E Check applicable boxes: (1) ☐ Initial return (2) ☐ Change in address
F Check method of accounting: (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) ▶

Income	1a	Gross receipts or sales 248,000 b Less returns and allowances 7,500 c Balance ▶		1c	240,500
	2	Cost of goods sold (see instructions)		2	144,000
	3	Gross profit (line 1c less line 2)		3	96,500
	4	Domestic corporation dividends subject to the 70% deduction		4	
	5	Interest		5	942
	6	Gross rents		6	
	7	Gross royalties		7	
	8	Capital gain net income (attach Schedule D (Form 1120))		8	
	9	Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)		9	
	10	Other income (see instructions)		10	
	11	**Total income**—Add lines 3 through 10 ▶		11	97,442
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions)		12	23,000
	13a	Salaries and wages 24,320 b Less jobs credit c Balance ▶		13c	24,320
	14	Repairs		14	
	15	Bad debts		15	
	16	Rents		16	6,000
	17	Taxes		17	3,320
	18	Interest		18	1,340
	19	Contributions (**see instructions for 10% limitation**)		19	1,820
	20	Depreciation (attach Form 4562)	20		
	21	Less depreciation claimed elsewhere on return	21a	21b	
	22	Other deductions (attach schedule) (Advertising)		22	3,000
	23	**Total deductions**—Add lines 12 through 22 ▶		23	62,800
	24	Taxable income before net operating loss deduction and special deductions (line 11 less line 23)		24	34,642
	25	**Less:** a Net operating loss deduction (see instructions)	25a		
		b Special deductions (see instructions)	25b	25c	
Tax and Payments	26	**Taxable income**—Line 24 less line 25c		26	34,642
	27	**Total tax** (Part I, line 7)		27	5,196
	28	**Payments:**			
	a	1989 overpayment credited to 1990 28a			
	b	1990 estimated tax payments 28b 6,000			
	c	Less 1990 refund applied for on Form 4466 28c ( ) Bal ▶	28d 6,000		
	e	Tax deposited with Form 7004	28e		
	f	Credit from regulated investment companies (attach Form 2439)	28f		
	g	Credit for Federal tax on fuels (attach Form 4136). See instructions	28g		
	h	**Total payments**—Add lines 28d through 28g		28h	6,000
	29	Enter any **penalty** for underpayment of estimated tax—Check ▶ ☐ if Form 2220 is attached		29	
	30	**Tax due**—If the total of lines 27 and 29 is larger than line 28h, enter amount owed		30	
	31	**Overpayment**—If line 28h is larger than the total of lines 27 and 29, enter amount overpaid		31	804
	32	Enter amount of line 31 you want: **Credited to 1991 estimated tax** ▶ 804 **Refunded** ▶		32	

Please Sign Here
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ George Rose Signature of officer | 2-15-91 Date | ▶ President Title

Paid Preparer's Use Only
Preparer's signature ▶ | Date | Check if self-employed ▶ ☐ | Preparer's social security number
Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

Form **1120-A** (1990)

For Paperwork Reduction Act Notice, see page 1 of the Instructions.

Form 1120-A (1990) **Page 2**

Part I Tax Computation

1	Income tax (see Instructions to figure the tax). Check this box if the corp. is a qualified personal service corp. (see Instructions). ▶ ☐	1	5,196
2a	General business credit. Check if from: ☐ Form 3800 ☐ Form 3468 ☐ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586 — 2a		
b	Credit for prior year minimum tax (attach Form 8801) — 2b		
3	**Total credits**—Add lines 2a and 2b	3	
4	Line 1 less line 3	4	5,196
5	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611	5	
6	Alternative minimum tax (attach Form 4626). See Instructions	6	
7	**Total tax**—Add lines 4 through 6. Enter here and on line 27, page 1.	7	5,196

Additional Information (See General Instruction F.)

G Refer to the list in the Instructions and state the principal:

(1) Business activity code no. ▶ 5995

(2) Business activity ▶ Flower Shop

(3) Product or service ▶ Flowers

H Did any individual, partnership, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) Yes ☑ No ☐

If "Yes," attach schedule showing name, address, and identifying number. (Schedule not illustrated)

I Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ -0-

J (1) If an amount for cost of goods sold is entered on line 2, page 1, complete (a) through (c):

(a) Purchases (see Instructions)	134,014
(b) Additional sec. 263A costs (see Instructions —attach schedule)	
(c) Other costs (attach schedule)	9,466

(2) Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the corporation? Yes ☐ No ☑

K At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See General Instruction F for filing requirements for form TD F 90-22.1.) Yes ☐ No ☑

If "Yes," enter the name of the foreign country ▶

L Enter amount of cash distributions and the book value of property (other than cash) distributions made in this tax year ▶ $ -0-

Part II Balance Sheets

			(a) Beginning of tax year	(b) End of tax year
Assets	1	Cash	20,540	18,498
	2a	Trade notes and accounts receivable		
	b	Less allowance for bad debts	( )	( )
	3	Inventories	2,530	2,010
	4	U.S. government obligations	13,807	45,479
	5	Tax-exempt securities (see Instructions)		
	6	Other current assets (attach schedule)		
	7	Loans to stockholders		
	8	Mortgage and real estate loans		
	9a	Depreciable, depletable, and intangible assets		
	b	Less accumulated depreciation, depletion, and amortization	( )	( )
	10	Land (net of any amortization)		
	11	Other assets (attach schedule)		
	12	Total assets	36,877	65,987
Liabilities and Stockholders' Equity	13	Accounts payable	6,415	6,079
	14	Other current liabilities (attach schedule)		
	15	Loans from stockholders		
	16	Mortgages, notes, bonds payable		
	17	Other liabilities (attach schedule)		
	18	Capital stock (preferred and common stock)	20,000	20,000
	19	Paid-in or capital surplus		
	20	Retained earnings	10,462	39,908
	21	Less cost of treasury stock	( )	( )
	22	Total liabilities and stockholders' equity	36,877	65,987

Part III Reconciliation of Income per Books With Income per Return (Must be completed by all filers.)

1 Net income per books	29,446		
2 Federal income tax	5,196	6 Income recorded on books this year not included on this return (itemize)	
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize)		7 Deductions on this return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted on this return (itemize)		8 Income (line 24, page 1). Enter the sum of lines 1 through 5 less the sum of lines 6 and 7	34,642

40. Form 1120—Corporation

Tentex Toys, Inc., is the corporation for which the sample return is filled out. Tentex is engaged in the business of manufacturing and selling children's toys and games. It uses an accrual method of accounting and files its returns on the calendar year.

Page 1

If possible, when you prepare your return you should use the pre-addressed forms sent to you by the Internal Revenue Service. The pre-addressed label is designed to expedite processing and prevent errors. If you do not get a corporation tax form with a pre-addressed label, enter your corporation's name, the street address, and the city, state, and ZIP code in the appropriate spaces on the first page. After entering the identifying information called for at the top of the page, Tentex proceeds to report its items of income and deductions.

The name and employer identification number of the corporation should also be shown in the top margin of schedules and attachments to Form 1120.

Fill in applicable lines. All applicable items for income, deductions, tax and payments listed on page 1 of Form 1120 should be filled in even though totals must be shown on the printed forms. Do not alter, substitute for, or cross out the line captions on the official return forms.

Line 1. Gross sales, line 1a, for the year totaled $2,010,000, using the accrual basis of accounting. After subtracting returned goods and allowances of $20,000, line 1b, a net sales figure of $1,990,000 is entered on line 1c.

Line 2. Cost of goods sold is deducted on line 2. This figure, $1,520,000, is the total from Schedule A (line 7) on page 2.

Line 3. Net sales less cost of goods sold results in gross profit of $470,000.

Lines 4—10. Other items of income are shown next. During the year, Tentex received $10,000 of dividends from domestic corporations, $5,000 of tax-exempt interest from state bonds, and $4,000 of taxable interest. It also received $500 interest on its business accounts receivable. The gross amount of dividends is entered on line 4 (note that the dividends-received deduction is taken on line 29b). Total taxable interest of $4,500 is shown on line 5. The tax-exempt interest is not included in income.

A section 481 adjustment of $1,000 is shown on line 10. This is due to the revalued beginning inventory (from a previous year) required by the uniform capitalization rules of section 263A (attached computation not illustrated). See Publication 538, *Accounting Periods and Methods,* for more information on the uniform capitalization rules.

Line 11. Total income is $485,500.

Line 12. The salaries of the company president, vice president, and secretary-treasurer, listed on Schedule E, total $70,000 and are included on line 12. Schedule E is completed only if total receipts (line 1a plus lines 4 through 10 of page 1) are $500,000 or more.

Line 13. Other salaries and wages total $44,000 and are listed on line 13a. This includes only salaries and wages not included on line 12, and not deducted as part of cost of goods sold on line 3, Schedule A on page 2. For a manufacturing company such as Tentex, this amount represents nonmanufacturing salaries and wages, such as office salaries. See Chapter 10 for a discussion of salaries and wages. Tentex is eligible for a $6,000 targeted jobs credit (which is figured on Form 5884 (not illustrated)). The deduction for salaries and wages is reduced on line 13b by the allowable $6,000 credit. The balance, $38,000, is entered on line 13c.

Line 14. Repairs include only payments for items that do not add to the value of the assets repaired or substantially increase their useful lives. Repairs total $800. For information on repairs, see Chapter 19.

Line 15. Tentex uses the specific charge-off method of accounting for bad debts. Actual accounts written off during the year total $1,600. See Chapter 14 for information on bad debt deductions.

Line 16. Rental expense for Tentex's office facilities was $9,200 for the year.

Line 17. Deductible taxes totaled $15,000.

Line 18. Interest expense accrued during the year amounted to $27,200. This included interest both on debts for business operations and debts to carry investments. Interest to carry tax-exempt securities is not included. See Chapter 16 for a discussion of amounts deductible as interest.

Line 19. During 1990, Tentex contributed $11,400 to the United Community Fund and $12,600 to the State University scholarship fund. The total of $24,000 is more than the limit for deductible contributions, which is 10% of taxable income figured without regard to the contribution deduction and the special deduction entered on line 29b. The amount allowable under the limitation is $23,150, and this is entered on line 19. The excess of $850, not deductible this year, may be carried over as explained in Chapter 29. Also, during 1990, Tentex made contributions of $500 which are not deductible in any case.

Lines 20 and 21. Depreciation of $17,600 is brought forward from Form 4562 (not illustrated) and entered on line 20. This amount is reduced by the depreciation claimed on Schedule A ($12,400) and entered on line 21a. The balance ($5,200) is deducted on line 21b since it is the depreciation on the assets used in the indirect operations of the business.

Line 23. Advertising expense of $8,700 is entered on line 23.

Line 26. Other business deductions totaled $78,300. These included miscellaneous office expenses, sales commissions, legal fees, etc. A schedule itemizing these expenses must be attached to the return, even though it has not been shown in this example.

Line 27. Total deductions amount to $277,150. This figure is listed on line 27.

Lines 28, 29, and 30. Taxable income, $208,350, is shown on line 28. Since Tentex did not have a net operating loss, its only entry on line 29 is the special dividends-received deduction of $8,000 brought forward from Schedule C, page 2. Taxable income on line 30 is $200,350.

Tax summary. Enter on line 31 the total tax ($55,387) from Schedule J. Payments against the tax are listed on line 32, Form 1120. On the Tentex return, the only credit is for the four estimated tax payments totaling $69,117 that is entered on lines 32b, 32d, and 32h. The resulting overpayment is $13,730, which Tentex chooses to have credited to its 1991 estimated tax. Tentex could have had the overpayment refunded if it had wanted to.

Signature. Tentex's return must be signed manually by a corporate officer who is authorized to sign it.

Page 2

Schedule A. Use Schedule A to report your cost of goods sold. Basically, this figure is beginning inventory, plus merchandise bought or produced during the year, less ending inventory. Because it is a manufacturer, Tentex must account for its costs of manufacturing as part of cost of goods sold. Goods on hand at the beginning of the year were valued at $126,000, using the lower of cost or market method of inventory valuation.

Cost of goods manufactured during the year is added to beginning inventory. This cost is made up of three items: direct materials, direct labor, and overhead. Materials cost of $1,127,100 is listed on line 2; this includes subcontracted parts as well as raw materials. Salaries and wages of $402,000 are entered on line 3. This amount includes wages paid to production-line workers, and also the part of supervisory salaries attributable to actual production of goods. Do not deduct payments already deducted on lines 12 or 13 of page 1.

Other costs of $163,300 appear on line 4b. The supporting itemization is not illustrated, but these costs consist basically of factory overhead, such as electricity, fuel, water, small tools, and depreciation on production-line machinery. Note that this depreciation ($12,400) represents depreciation on the assets used in the direct manufacturing operations of the business; see page 1, line 21. See Chapter 8 for a detailed discussion of cost of goods sold.

Check boxes. All applicable boxes on line 8, Schedule A, should be checked.

Schedule C. Dividend income amounted to $10,000, all of which qualified for the 80% dividends-received deduction, line 2, because Tentex is a 20%-or-more owner. This total is shown both here and on line 4 of page 1. The total dividends-received deduction is also figured on Schedule C and entered both here and on line 29b of page 1.

Schedule E. You should complete this schedule only if your total receipts (line 1a plus lines 4 through 10 of page 1, Form 1120) are $500,000 or more. (Tentex meets this requirement.) Since Tentex has only three corporate officers, these are the only entries in the schedule. Only compensation for services rendered is included here. Do not include dividends on stock held by the corporate officers.

Page 3

Schedule J. Schedule J is used to figure the corporation's tax. Applying the rates to Tentex's taxable income of $200,350 results in income tax of $61,387. This figure is decreased by the jobs credit of $6,000, resulting in a total tax of $55,387.

The jobs credit is figured by multiplying $15,000 of wages paid to five qualified summer youth clerical employees (who were certified as members of a targeted group) in their first year of employment by the 40% rate. Each employee earned $3,000 in salary in 1990. Form 5884 (not illustrated) should be filed with Tentex's return to support these credits.

The other taxes and credits listed on Schedule J do not apply to Tentex for 1990.

Additional Information. All applicable questions on page 3 must be answered for the return to be complete.

Page 4

Schedule L. Comparative balance sheets for the beginning and end of the tax year must be shown on Schedule L. Entries on this page should agree with amounts shown elsewhere on the return. For example, the figures for beginning and ending inventories must be the same as those appearing on Schedule A. Note that the appropriated retained earnings of Tentex increased from $30,000 to $40,000 during the year, due to the setting aside of $10,000 as a reserve for contingencies. This amount was taken out of unappropriated retained earnings, as shown on Schedule M–2.

Schedules M–1 and M–2 must be completed if the total assets (line 15, column (d), Schedule L) are $25,000 or more. To properly complete these schedules, you must first get additional information from your corporation's books and records. The following profit and loss account appeared in the books of Tentex for the calendar year 1990.

Account		Debit	Credit
Gross sales			$2,010,000
Sales returns and allowances		$ 20,000	
Cost of goods sold		1,520,000	
Dividends received			10,000
Interest income:			
On state bonds	$ 5,000		
Other–taxable	4,500		9,500
Other income			1,000
Proceeds of life insurance			9,500
Premiums on life insurance		9,500	
Compensation of officers		70,000	
Salaries and wages–indirect		44,000	
Repairs		800	
Bad debts		1,600	
Rental expense		9,200	
Taxes		15,000	
Interest expense:			
On loan to buy tax-exempt bonds	$ 850		
Other	27,200	28,050	
Contributions:			
Deductible	$24,000		
Nondeductible	500	24,500	
Depreciation–indirect		3,580	
Advertising		8,700	
Other expenses of operation		78,300	
Loss on securities		3,600	
Federal income tax accrued		55,387	
Net income per books after tax		147,783	
Total		$2,040,000	$2,040,000

Retained earnings were analyzed and the following appeared in this account in the books of the corporation:

Item	Debit	Credit
Balance, January 1, 1990		$238,000
Net profit (before federal income tax)		203,170
Reserve for contingencies	$ 10,000	
Income tax accrued for 1990	55,387	
Dividends paid during 1990	65,000	
Refund of 1988 income tax		18,000
Balance, December 31, 1990	328,783	
Total	$459,170	$459,170

Schedule M–1. Schedule M–1 starts with the net income per books, after allowance of federal income tax accrued, as shown in the corporation's profit and loss account. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 28, page 1.

Line 1. Line 1 is net income per books, $147,783 as shown in the Profit and Loss Account previously as net income per books after tax.

Line 2. Line 2 is the federal income tax accrued for the year of the return, $55,387.

Line 3. Line 3 is for the capital losses that exceed capital gains. The net loss on securities, $3,600, is entered on this line.

Line 4. Line 4 should show all income and credits included in income subject to tax that are not recorded on the books for this year. This can happen if assets are valued in the corporate books at an amount greater than that used for tax purposes. When a sale of such assets is made, the gain included in taxable income is greater than that recorded on the books, and the difference is shown here.

Line 5. Line 5 is for expenses recorded on the corporation's books that may not be deducted. Besides the $850 listed on line 5b as contributions that were over the 10% limit, the remaining nondeductible expenses are shown in an itemized statement attached to the return, which is not illustrated, that would include the following:

Premiums paid on term life insurance on corporate officers	$ 9,500
Interest paid to purchase tax-exempt securities	850
Nondeductible contributions	500
Reduction of salaries by the targeted jobs credit	6,000
Total	$16,850

Line 6. Line 6 is the total of lines 1 through 5.

Line 7. Line 7 shows nontaxable income recorded on the corporation's books during the year that is not on the return. This totals $14,500, and includes insurance proceeds of $9,500 and interest on state bonds of $5,000.

Line 8. Line 8 includes all deductions claimed for tax purposes that are not recorded in the corporation's books. Tentex enters $1,620 on line 8a; it represents the difference between depreciation claimed on the tax return and the corporation's books. If the corporation had other deductions to itemize on this line and there wasn't enough space on the line, it would have to attach a statement to the return listing them.

Line 9. Line 9 shows the total of lines 7 and 8, or $16,120.

Line 10. Line 10, $208,350, is the difference between lines 6 and 9 and must agree with line 28, page 1, *Taxable income before net operating loss deduction and special deductions.*

Schedule M–2. Schedule M–2 analyzes the unappropriated retained earnings as shown in Schedule L, the corporation's balance sheets.

Line 1. This figure is taken from Schedule L for the beginning of the tax year. Tentex enters $238,000 on this line.

Line 2. Line 2 is the net income per books (after federal income tax), $147,783.

Line 3. Line 3 must show all other increases to retained earnings. The refund of 1988 income tax, $18,000, is entered on this line.

Line 4. Line 4 shows the total of lines 1, 2, and 3.

Line 5. Line 5 must include all distributions to shareholders charged to retained earnings during the tax year. The dividends paid, $65,000, are shown on this line.

Line 6. Line 6 is for any decreases (other than those on line 5) in unappropriated retained earnings. These decreases are not deductible on the tax return at the time of the appropriation, but a deduction may be allowable at a later date. A common example of this is amounts set aside for contingencies. A customer was injured on company property during 1990, and the company retained an attorney. A contingent liability of $10,000 was set up for the customer's claim. If this claim is settled during 1991 for $5,000 and the attorney's fee is $2,500, the retained earnings (appropriated) would be charged $7,500. The $7,500 would be deducted in arriving at taxable income for 1991. Another common example of items entered on this line is the payment of prior years' federal tax. A schedule must be attached to the return listing all items taken into account to arrive at the amount shown on this line.

Line 7. Line 7 shows the total of lines 5 and 6.

Line 8. Line 8 shows the retained earnings of the corporation at the end of the tax year for which the return is made. This figure is determined by subtracting the total on line 7 from the total on line 4. This figure must agree with the amount shown on Schedule L for the end of the year for which the return is made. As shown, $328,783 is entered in Schedule L.

Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1990 or tax year beginning ...., 1990, ending ...., 19 ....
▶ Instructions are separate. See page 1 for Paperwork Reduction Act Notice.

OMB No 1545-0123
1990

Check if a—
A Consolidated return ☐
B Personal holding co ☐
C Personal service corp (as defined in Temp Regs sec 1 441-4T—see instructions) ☐

Use IRS label. Otherwise, please print or type.
10-0395674 DEC90 071 3998
TENTEX TOYS, INC.
36 DIVISION STREET
ANYTOWN, IL 60930

IRS

D Employer identification number
E Date incorporated 3-1-72
F Total assets (see Specific instructions) $ 879,417

G Check applicable boxes (1) ☐ Initial return (2) ☐ Final return (3) ☐ Change in address

Income	1a	Gross receipts or sales $2,010,000 b Less returns and allowances $ 20,000 c Bal ▶			1c	1,990,000
	2	Cost of goods sold (Schedule A, line 7)			2	1,520,000
	3	Gross profit (line 1c less line 2)			3	470,000
	4	Dividends (Schedule C, line 19)			4	10,000
	5	Interest			5	4,500
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)			9	
	10	Other income (see instructions—attach schedule)			10	1,000
	11	**Total income**—Add lines 3 through 10 ▶			11	485,500
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)			12	70,000
	13a	Salaries and wages 44,000 b Less jobs credit 6,000 c Balance ▶			13c	38,000
	14	Repairs			14	800
	15	Bad debts			15	1,600
	16	Rents			16	9,200
	17	Taxes			17	15,000
	18	Interest			18	27,200
	19	Contributions (**see instructions for 10% limitation**)			19	23,150
	20	Depreciation (attach Form 4562)	20	17,600		
	21	Less depreciation claimed on Schedule A and elsewhere on return	21a	12,400	21b	5,200
	22	Depletion			22	
	23	Advertising			23	8,700
	24	Pension, profit-sharing, etc., plans			24	
	25	Employee benefit programs			25	
	26	Other deductions (attach schedule)			26	78,300
	27	**Total deductions**—Add lines 12 through 26 ▶			27	277,150
	28	Taxable income before net operating loss deduction and special deductions (line 11 less line 27)			28	208,350
	29	**Less:** a Net operating loss deduction (see instructions)	29a			
		b Special deductions (Schedule C, line 20)	29b	8,000	29c	8,000
Tax and Payments	30	**Taxable income**—Line 28 less line 29c			30	200,350
	31	**Total tax** (Schedule J, line 10)			31	55,387
	32	**Payments:** a 1989 overpayment credited to 1990 32a				
		b 1990 estimated tax payments 32b 69,117				
		c Less 1990 refund applied for on Form 4466 32c ( ) d Bal ▶	32d	69,117		
		e Tax deposited with Form 7004	32e			
		f Credit from regulated investment companies (attach Form 2439)	32f			
		g Credit for Federal tax on fuels (attach Form 4136). See instructions	32g		32h	69,117
	33	Enter any **penalty** for underpayment of estimated tax—Check ▶ ☐ if Form 2220 is attached			33	
	34	**Tax due**—If the total of lines 31 and 33 is larger than line 32h, enter amount owed			34	
	35	**Overpayment**—If line 32h is larger than the total of lines 31 and 33, enter amount overpaid			35	13,730
	36	Enter amount of line 35 you want: **Credited to 1991 estimated tax ▶** 13,730 **Refunded ▶**			36	

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ James Q. Barclay | 3-7-91 | ▶ President
Signature of officer | Date | Title

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's social security number
Firm's name (or yours if self-employed) and address ▶ | E.I. No. ▶ | ZIP code ▶

Schedule A Cost of Goods Sold (See Instructions for line 2, page 1.)

1	Inventory at beginning of year	1	126,000
2	Purchases	2	1,127,100
3	Cost of labor	3	402,000
4a	Additional section 263A costs (see Instructions—attach schedule)	4a	
b	Other costs (attach schedule)	4b	163,300
5	**Total**—Add lines 1 through 4b	5	1,818,400
6	Inventory at end of year	6	298,400
7	**Cost of goods sold**—Line 5 less line 6. Enter here and on line 2, page 1.	7	1,520,000

8a Check all methods used for valuing closing inventory:

(i) ☐ Cost (ii) ☑ Lower of cost or market as described in Regulations section 1.471-4 (see Instructions)

(iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c) (see Instructions)

(iv) ☐ Other (Specify method used and attach explanation.) ▶

b Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO 8c

d Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the corporation? ☑ Yes ☐ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☑ No

Schedule C Dividends and Special Deductions (See Instructions.)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)	10,000	80	8,000
3	Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		41.176	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		47.059	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs that are subject to the 70% deduction		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs that are subject to the 80% deduction		80	
8	Dividends from wholly owned foreign subsidiaries subject to the 100% deduction (section 245(b))		100	
9	**Total**—Add lines 1 through 8. See Instructions for limitation			8,000
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from certain FSCs that are subject to the 100% deduction (section 245(c)(1))		100	
12	Dividends from affiliated group members subject to the 100% deduction (section 243(a)(3))		100	
13	Other dividends from foreign corporations not included on lines 3, 6, 7, 8, or 11			
14	Income from controlled foreign corporations under subpart F (attach Forms 5471)			
15	Foreign dividend gross-up (section 78)			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3 (section 246(d))			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities (see Instructions)			
19	**Total dividends**—Add lines 1 through 17. Enter here and on line 4, page 1. ▶	10,000		
20	**Total deductions**—Add lines 9, 10, 11, 12, and 18. Enter here and on line 29b, page 1 ▶			8,000

Schedule E Compensation of Officers (See Instructions for line 12, page 1.)

Complete Schedule E only if total receipts (line 1a, plus lines 4 through 10, of page 1, Form 1120) are $500,000 or more.

(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1 James Q. Barclay	581-00-0936	100 %	45 %	%	40,000
		%	%	%	
George M. Collins	447-00-2604	100 %	15 %	%	21,000
		%	%	%	
Samuel Adams	401-00-2611	50 %	2 %	%	9,000

2 Total compensation of officers	70,000
3 **Less:** Compensation of officers claimed on Schedule A and elsewhere on return	( )
4 Compensation of officers deducted on line 12, page 1	70,000

Schedule J Tax Computation

1 Check if you are a member of a controlled group (see sections 1561 and 1563) ▶ ☐				
2 If the box on line 1 is checked:				
a Enter your share of the $50,000 and $25,000 taxable income bracket amounts (in that order): (i) $ (ii) $				
b Enter your share of the additional 5% tax (not to exceed $11,750) ▶ $				
3 Income tax (see Instructions to figure the tax). Check this box if the corporation is a qualified personal service corporation (see Instructions on page 12). ▶ ☐			3	61,387
4a Foreign tax credit (attach Form 1118)	4a			
b Possessions tax credit (attach Form 5735)	4b			
c Orphan drug credit (attach Form 6765)	4c			
d Credit for fuel produced from a nonconventional source (see Instructions)	4d			
e General business credit. Enter here and check which forms are attached: ☐ Form 3800 ☐ Form 3468 ☑ Form 5884 ☐ Form 6478 ☐ Form 6765 ☐ Form 8586	4e	6,000		
f Credit for prior year minimum tax (attach Form 8801)	4f			
5 **Total**—Add lines 4a through 4f			5	6,000
6 Line 3 less line 5			6	55,387
7 Personal holding company tax (attach Schedule PH (Form 1120))			7	
8 Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611			8	
9a Alternative minimum tax (attach Form 4626). See Instructions			9a	
b Environmental tax (attach Form 4626)			9b	
10 **Total tax**—Add lines 6 through 9b. Enter here and on line 31, page 1			10	55,387

Additional Information (See General Instruction F.)

	Yes	No
H Refer to the list in the Instructions and state the principal: (1) Business activity code no. ▶ 3998 (2) Business activity ▶ Manufacturing (3) Product or service ▶ Toys		
I (1) Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).)		✓
If "Yes," attach a schedule showing: (a) name, address, and identifying number; (b) percentage owned; and (c) taxable income or (loss) before NOL and special deductions of such corporation for the tax year ending with or within your tax year.		
(2) Did any individual, partnership, corporation, estate, or trust at the end of the tax year own, directly or indirectly, 50% or more of the corporation's voting stock? (For rules of attribution, see section 267(c).) If "Yes," complete (a) through (c)		✓
(a) Attach a schedule showing name, address, and identifying number.		
(b) Enter percentage owned ▶		
(c) Was the owner of such voting stock a foreign person? (See Instructions.) **Note:** *If "Yes," the corporation may have to file Form 5472*		
If "Yes," enter owner's country ▶		
J Was the corporation a U.S. shareholder of any controlled foreign corporation? (See sections 951 and 957.)		✓
If "Yes," attach Form 5471 for each such corporation.		
K At any time during the tax year, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)?		✓
(See General Instruction F and filing requirements for form TD F 90-22.1.) If "Yes," enter name of foreign country ▶		
L Was the corporation the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the corporation has any beneficial interest in it?		✓
If "Yes," the corporation may have to file Forms 3520, 3520-A, or 926.		
M During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.)		✓
If "Yes," file Form 5452. If this is a consolidated return, answer here for parent corporation and on Form 851, Affiliations Schedule, for each subsidiary.		
N During this tax year, did the corporation maintain any part of its accounting/tax records on a computerized system?		✓
O Check method of accounting: (1) ☐ Cash (2) ☑ Accrual (3) ☐ Other (specify) ▶		
P Check this box if the corporation issued publicly offered debt instruments with original issue discount ☐ If so, the corporation may have to file Form 8281.		
Q Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ 5,000		
R Enter the number of shareholders at the end of the tax year if there were 35 or fewer shareholders ▶		

Schedule L Balance Sheets

	Beginning of tax year		End of tax year	
Assets	(a)	(b)	(c)	(d)
1 Cash		14,700		28,331
2a Trade notes and accounts receivable	98,400		103,700	
b Less allowance for bad debts	( )	98,400	( )	103,700
3 Inventories		126,000		298,400
4 U.S. government obligations				
5 Tax-exempt securities (see Instructions)		100,000		120,000
6 Other current assets (attach schedule)		26,300		17,266
7 Loans to stockholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)		100,000		80,000
10a Buildings and other depreciable assets	272,400		296,700	
b Less accumulated depreciation	(88,300)	184,100	(104,280)	192,420
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)		20,000		20,000
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach schedule)		14,800		19,300
15 Total assets		684,300		879,417
Liabilities and Stockholders' Equity				
16 Accounts payable		28,500		34,834
17 Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18 Other current liabilities (attach schedule)		6,800		7,400
19 Loans from stockholders				
20 Mortgages, notes, bonds payable in 1 year or more		176,700		264,100
21 Other liabilities (attach schedule)				
22 Capital stock: a Preferred stock				
b Common stock	200,000	200,000	200,000	200,000
23 Paid-in or capital surplus				
24 Retained earnings—Appropriated (attach schedule)		30,000		40,000
25 Retained earnings—Unappropriated		238,000		328,783
26 Less cost of treasury stock		( )		( )
27 Total liabilities and stockholders' equity		684,300		879,417

Schedule M-1 Reconciliation of Income per Books With Income per Return

(This schedule does not have to be completed if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income per books	147,783	7 Income recorded on books this year not included on this return (itemize):	
2 Federal income tax	55,387	a Tax-exempt interest $ 5,000	
3 Excess of capital losses over capital gains	3,600	b Insurance Proceeds 9,500	14,500
4 Income subject to tax not recorded on books this year (itemize):		8 Deductions on this return not charged against book income this year (itemize):	
5 Expenses recorded on books this year not deducted on this return (itemize):		a Depreciation $ 1,620	
a Depreciation $		b Contributions carryover $	
b Contributions carryover $ 850			
c Travel and entertainment $			
See Itemized			1,620
Statement Attached $16,850	17,700	9 Total of lines 7 and 8	16,120
6 Total of lines 1 through 5	224,470	10 Income (line 28, page 1)—line 6 less line 9	208,350

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (line 25, Schedule L)

(This schedule does not have to be completed if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Balance at beginning of year	238,000	5 Distributions: a Cash	65,000
2 Net income per books	147,783	b Stock	
3 Other increases (itemize):		c Property	
Refund of 1988 Income Tax		6 Other decreases (itemize):	
Due to IRS Examination		Reserve for Contingencies	10,000
	18,000	7 Total of lines 5 and 6	75,000
4 Total of lines 1, 2, and 3	403,783	8 Balance at end of year (line 4 less line 7)	328,783

41. Form 1120S — S Corporation

Estex Inc., is engaged in the distribution of machinery, equipment, and supplies for the building trades. It uses an accrual method of accounting and files its returns on the calendar year. In December 1989, Estex Inc., made a timely and proper election to be treated as an S corporation.

Page 1

When you prepare the corporation's return for 1990, use the pre-addressed label sent to you by the IRS. The pre-addressed label is designed to expedite processing and prevent errors. If you do not have such a label, enter your corporation's name, the street address, room number, suite, or unit, and the city, state, and ZIP code in the appropriate spaces on the first page. After entering the identifying information at the top of the page, you should proceed to report in summary form Estex's items of income and deductions.

The name and employer identification number of the corporation should be shown in the top margin of all schedules and other attachments to Form 1120S.

Line Items. All applicable items for income, deductions, and tax listed on page 1 of Form 1120S should be filled in, even though totals may be shown in schedules attached to the return. Do not alter, substitute, or cross out the line captions printed on the official return forms.

Line 1. Gross sales for the year totaled $1,545,700 (line 1a), determined on the accrual method of accounting. After subtracting returned goods and allowances of $21,000 (line 1b), net sales of $1,524,700 are entered on line 1c.

Line 2. Cost of goods sold is deducted on line 2. This figure, $954,700 is the total from Schedule A (line 7) on page 2.

Line 3. Net sales minus cost of goods sold result in gross profit of $570,000.

Line 6. Total income on line 6 is $570,000.

Line 7. The salaries of the company president, vice president, and secretary-treasurer total $170,000 and are included on line 7. Compensation paid to corporate officers must be separated from other salaries and wages and must be entered on line 7 rather than on line 8.

Line 8. Other salaries and wages are entered on line 8a. The entry includes only salaries and wages not included on line 7 and not deducted as part of cost of goods sold. Salaries and wages of $144,000 on line 8a are reduced by $6,000, the amount of the jobs credit, discussed later, passed through to the shareholders on line 8b.

Line 9. Repairs include only payments for items that do not add to the value of the assets repaired or substantially increase their useful lives. Estex incurred $800 for repairs.

Line 10. Estex must use the specific charge-off method for bad debts. Actual accounts written off during the year total $1,600.

Line 11. Rental expense for Estex's office and service building was $9,200 for the year.

Line 12. Deductible taxes totaled $15,000.

Line 13. Interest expense accrued during the year amounted to $24,200. This included interest on debts for business operations only. Interest of $850 to carry tax-exempt securities and investments is not included. Interest on the debt to carry investments that produce taxable income is $3,000. It is shown on line 11a of Schedule K and passed through to the shareholders on Schedule K-1.

Lines 14a and 14b. Depreciation of $5,200 is brought forward from Form 4562, *Depreciation and Amortization* (not illustrated). If Estex had a section 179 deduction, it would not be included here. It is passed through to the shareholders on Schedule K-1.

Line 16. Advertising expense of $8,700 is entered on line 16.

Line 19. Other ordinary and necessary business deductions totaled $78,300. These included miscellaneous office expenses, sales commissions, legal fees, etc. A schedule itemizing these expenses must be attached to the return, even though it is not shown.

Line 20. Total deductions are $451,000.

Line 21. Ordinary income (nonseparately stated income) is $119,000.

Corporate officer's signature. The corporation return must be signed manually by the corporate officer authorized to sign. Use of the corporate seal is optional.

Page 2

Schedule A. Use Schedule A to report the cost of goods sold. This figure is beginning inventory plus merchandise bought or produced during the year minus ending inventory.

Line 1. Because it is a distributor, Estex accounts for its purchasing costs as part of the cost of goods sold. Goods on hand at the beginning of the year were properly valued at $126,000, using the lower of cost or market valuation method. Estex must report this amount on line 1.

Line 2. Purchases cost of $1,127,100 is listed on line 2.

Line 6. Estex had goods on hand at the end of the year properly valued at $298,400. Estex must report that amount on line 6.

Lines 8a — 8e. All applicable questions on these lines should be answered.

Additional Information. All applicable questions in this section should be answered. Also indicate the business activity, product, or service, and check the appropriate boxes.

Designation of tax matters person. The identification information relating to the shareholder designated as the tax matters person should be provided as indicated at the bottom of page 2, Form 1120S.

Page 3

Schedule K. Schedule K summarizes the corporation's income, deductions, credits, etc., that are reportable by the shareholders.

Line 1. On line 1, Estex shows the ordinary income (nonseparately stated income) of $119,000 from line 21, page 1.

Line 4. Line 4 is used to report portfolio income and loss items. Portfolio items include interest income, dividend income, royalty income, short-term capital gain or loss, and long-term capital gain or loss. Estex had the following portfolio items:

1) Taxable interest income of $4,000 reportable on line 4a, and
2) Taxable dividends of $16,000 reportable on line 4b.

Line 7. Line 7 is for charitable contributions. During 1990, Estex contributed $11,400 to the United Community Fund and $12,600 to the State University Scholarship Fund. The total of $24,000, subject to a 50% limitation, is entered in the total column on line 7.

Lines 11a and 11b(1). These lines show the items that must be taken into account by shareholders to figure their interest deduction on investment indebtedness. Line 11a is used for investment interest expense. Estex had investment interest expense of $3,000. Line 11b(1) is for investment income. Estex had taxable interest from investments (line 4a) totaling $4,000. Estex also had dividends from investments (line 4b) totaling $16,000. Therefore, Estex must enter $20,000 on line 11b(1). Each shareholder's share of these items must be reported on Schedule K-1, discussed later.

Line 13. Line 13 is for the jobs credit. Estex has $6,000 of jobs credit in 1990. The credit was figured on Form 5884, *Jobs Credit* (not shown here).

Line 17. Line 17 is for distributions other than those reported on line 19. Estex distributed $65,000 in 1990.

Line 18. Line 18 is for other adjustments that would affect shareholders' bases in their S corporation stock. In 1990, Estex earned $5,000 of tax-exempt interest from state bonds and had $6,000 of nondeductible salaries due to the jobs credit. A separate schedule of these amounts (not shown) is attached to the return.

Line 20. Taxable income of $112,000 from line 8, Schedule M-1, is entered here.

Schedule K-1. A separate Schedule K-1 is completed by the S corporation for each shareholder.

Generally, shareholders must treat items of income, loss, deduction, credit, etc., on their returns consistent with the way the S corporation reported them on its return. A shareholder who shows the items differently from the way the S corporation reported them on Schedule K-1 should complete Form 8082, *Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR)).*

A copy of each shareholder's Schedule K-1 should be filed with Form 1120S. A copy is kept as a part of the corporation's records, and each shareholder receives a copy with instructions attached.

Estex must prepare a Schedule K-1 for each shareholder. The illustrated Schedule K-1 is for John H. Anders who owns 9,000 shares (45%) of the corporation's stock, which he acquired on March 3, 1973. He devotes 100% of his time to the business for which he is paid $40,000.

Lines 1 through 10 are for each shareholder's distributive share of nonseparately stated income or loss and separately stated income or loss and deductions.

Line 1. Line 1 shows Mr. Anders' share of nonseparately stated income of $53,550. It makes no difference whether this income was distributed to him in 1990. Mr. Anders must report $53,550 on Schedule E (Form 1040) when he files his individual income tax return, Form 1040.

Line 4. Line 4 is for portfolio income and loss items. Mr. Anders' share of interest income is $1,800. His share of dividend income is $7,200.

Line 7. Line 7 is for Mr. Anders' share of Estex's charitable contributions for 1990. His share is $10,800. Because all Estex's contributions were given to public charities, they qualify for the 50% limitation.

Lines 11a and 11b(1). These lines are used to show each shareholder's share of interest on investment indebtedness. The amounts reported on these lines will be used to complete Form 4952, *Investment Interest Expense Deduction.* Line 11a shows Mr. Anders' share of Estex's investment interest expense, $1,350 (45% × $3,000). Investment interest expense is that part of Estex's total interest for loans made to carry its investment. Line 11b(1) shows Mr. Anders' share of Estex's investment income, $9,000 (45% × $20,000). This represents Estex's income from ordinary dividends and interest. It does not include interest on municipal bond investments, which is tax-exempt.

Line 13. Line 13 is for the jobs credit. Mr. Anders' share of Estex's jobs credit is $2,700 (45% × $6,000).

Line 17. Line 17 is for distributions paid during the year other than those paid from accumulated earnings and profits and reported on Form 1099–DIV. During 1990, Estex distributed $65,000. Mr. Anders' 45% share of the distribution was $29,250.

Line 21. Line 21 is for supplemental information and other items that would affect a shareholder's basis in S corporation stock, such as nontaxable income, nondeductible expenses, and income and expenses from oil and gas property used to figure shareholders' depletion, etc. In 1990, Estex had $5,000 of tax-exempt interest from state bonds, and $6,000 of nondeductible salaries due to the jobs credit. Mr. Anders' 45% share of the tax-exempt interest and nondeductible salaries and wages was $2,250 and $2,700, respectively. These amounts are shown here.

Page 4

Schedule L. Comparative balance sheets for the beginning and end of the tax year must be shown on Schedule L. Entries on this page should agree with amounts shown elsewhere on the return. For example, the figures for beginning and ending inventories must be the same as those appearing in the analysis of cost of goods sold. In addition, the figures on the balance sheet for the beginning of the tax year will normally agree with the balance sheet figures for the end of the last tax year.

Schedules M–1 and M–2. These schedules must be completed if the total assets (line 15, column (d), Schedule L) are $25,000 or more. To properly complete these schedules, you must first get additional information from your corporation's books and records.

The following appeared on the books of Estex for the calendar year 1990.

Account		Debit	Credit
Gross Sales			$1,545,700
Sales returns and allowances		$ 21,000	
Cost of goods sold		954,700	
Dividend income			16,000
Interest income (on state bonds)			5,000
(other—taxable)			4,000
Premiums on life insurance		9,500	
Compensation of officers		170,000	
Salaries and wages		144,000	
Repairs		800	
Bad debts		1,600	
Rental expense		9,200	
Taxes		15,000	
Interest expense on loan to buy tax-exempt bonds)	$ 850		
(other)	27,200	28,050	
Contributions		24,000	
Depreciation		3,580	
Advertising		8,700	
Other expenses of operation		78,300	
Net income per books		102,270	
Total		$1,570,700	$1,570,700

Schedule M–1. Schedule M–1 starts with the net income per books as shown in the corporation's books and records. It provides for necessary adjustments to reconcile this amount with the taxable income shown on line 20, Schedule K.

Line 1. This is the net income per books, $102,270, shown on the corporation's books.

Line 2. This should show all income and credits included in income subject to tax that are not recorded on the books for this year. This can happen if assets are valued on the corporate books at an amount greater than that used for tax purposes. When a sale of such assets is made, the gain included in taxable income is greater than that recorded on the books, and the difference is shown here.

Line 3. This is for expenses recorded on the corporation's books that may not be deducted. They are shown in an itemized statement attached to the return (not illustrated). It would include the following:

Premiums paid on term life insurance on corporate officers	$ 9,500
Interest paid to purchase tax-exempt securities	850
Reduction of salaries by jobs credit	6,000
Total	$16,350

Line 4. This is the total of lines 1 through 3.

Line 5. This shows nontaxable income recorded on the corporation's books during the year that is not on the return. This totals $5,000, the interest on state bonds.

Line 6. This includes all deductions claimed for tax purposes that are not recorded on the corporation's books. Estex enters $1,620 on line 6a. This represents the difference between depreciation claimed on the tax return and the corporation's books. If the corporation had other deductions to itemize on this line and there was not enough space on the line, it would have to attach a statement to the return listing them.

Line 7. This shows the total of lines 5 and 6, or $6,620.

Line 8. The difference, $112,000, between lines 4 and 7 must agree with line 20, Schedule K.

Schedule M–2. Schedule M–2 provides an analysis of certain earned equity accounts of the corporation for the tax year. The schedule shows the changes to the equity accounts for the income, deductions, distributions, etc., that are reported on the return for the tax year.

Column (a), Line 1. The first column is the accumulated adjustments account. For an S corporation's first year beginning after 1982, the initial balance in the account is zero. Estex enters zero on line 1.

Line 2. Estex's ordinary income for 1990 (page 1, line 21) is $119,000. This is entered on line 2.

Line 3. Estex enters $20,000 ($16,000 dividends plus $4,000 interest) on line 3. This is made up of amounts on lines 4a and 4b of Schedule K.

Line 4. Line 4 is for any loss shown on page 1, line 21. Because Estex has no losses in 1990, line 4 is zero.

Line 5. Estex enters $33,000 on line 5. This is made up of $3,000 interest on a loan to carry investments, $6,000 reduction in salaries and wages due to the jobs credit, and $24,000 charitable contributions.

Line 6. Line 6 is the total of lines 1 through 5, or $106,000.

Line 7. Line 7 is for distributions other than dividend distributions. Estex enters $65,000 on this line.

Line 8. Line 8 shows the balance in the accumulated adjustments account at the end of the year. Estex subtracts line 7 from line 6 and enters $41,000 here.

Column (b), Line 1. The second column is the other adjustments account. It is for other items, such as tax-exempt income and related expenses. For 1990, the balance at the beginning of the year is zero. This is entered on line 1.

Line 3. Estex had $5,000 of tax-free interest income from state bonds. This amount is entered on line 3.

Line 6. The total of lines 1 through 5, $5,000, is entered on line 6.

Line 7. Because the total distributions, other than dividends, did not exceed the balance in the accumulated adjustments account, none of the distribution is applied to the other adjustments account. Estex enters zero on line 7.

Line 8. The balance in the other adjustments account at the end of the year is $5,000. Estex enters this amount here.

Column (c). The third column is for undistributed taxable income that was included in shareholders' income for years that began before 1990. Since this is Estex's first year as an S corporation, there are no entries in this column.

Form **1120S**
Department of the Treasury
Internal Revenue Service

U.S. Income Tax Return for an S Corporation

For calendar year 1990, or tax year beginning ...., 1990, and ending ...., 19....

▶ See separate instructions.

OMB No. 1545-0130

1990

A Date of election as an S corporation: 12 - 1 - 89

B Business code no. (see Specific Instructions): 5008

Use IRS label. Otherwise, please print or type.

10-4487965 DEC90 D74 3070
ESTEX, INC.
482 WINSTON STREET
METRO CITY OH 43705

C Employer identification number: 10 - 4487965

D Date incorporated: 3 - 1 - 72

E Total assets (see Specific Instructions): $ 825, 714

F Check applicable boxes: (1) ☑ Initial return (2) ☐ Final return (3) ☐ Change in address (4) ☐ Amended return

G Check this box if this is an S corporation subject to the consolidated audit procedures of sections 6241 through 6245 (see instructions before checking this box) ▶ ☐

H Enter number of shareholders in the corporation at end of the tax year ▶ 6

Caution: *Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.*

Income	1a Gross receipts or sales 1,545,700 b Less returns and allowances 21,000 c Bal ▶	1c	1,524,700
	2 Cost of goods sold (Schedule A, line 7)	2	954,700
	3 Gross profit (subtract line 2 from line 1c)	3	570,000
	4 Net gain (loss) from Form 4797, Part II, line 18	4	-0-
	5 Other income (see instructions) *(attach schedule)*	5	-0-
	6 **Total** income (loss)—Combine lines 3 through 5 ▶	6	570,000
Deductions (See instructions for limitations.)	7 Compensation of officers	7	170,000
	8a Salaries and wages 144,000 b Less jobs credit 6,000 c Bal ▶	8c	138,000
	9 Repairs	9	800
	10 Bad debts	10	1,600
	11 Rents	11	9,200
	12 Taxes	12	15,000
	13 Interest	13	24,200
	14a Depreciation (see instructions) 14a 5,200		
	b Depreciation reported on Schedule A and elsewhere on return 14b -0-		
	c Subtract line 14b from line 14a	14c	5,200
	15 Depletion (**Do not deduct oil and gas depletion.** See instructions.)	15	-0-
	16 Advertising	16	8,700
	17 Pension, profit-sharing, etc., plans	17	-0-
	18 Employee benefit programs	18	-0-
	19 Other deductions *(attach schedule)*	19	78,300
	20 **Total** deductions—Add lines 7 through 19 ▶	20	451,000
	21 Ordinary income (loss) from trade or business activities—Subtract line 20 from line 6	21	119,000
Tax and Payments	22 **Tax:**		
	a Excess net passive income tax *(attach schedule)* 22a		
	b Tax from Schedule D (Form 1120S) 22b		
	c Add lines 22a and 22b (see instructions for additional taxes)	22c	-0-
	23 **Payments:**		
	a 1990 estimated tax payments 23a		
	b Tax deposited with Form 7004 23b		
	c Credit for Federal tax on fuels *(attach Form 4136)* 23c		
	d Add lines 23a through 23c	23d	-0-
	24 Enter any **penalty** for underpayment of estimated tax—Check ▶ ☐ if Form 2220 is attached	24	-0-
	25 **Tax due**—If the total of lines 22c and 24 is larger than line 23d, enter amount owed. See instructions for depositary method of payment ▶	25	-0-
	26 **Overpayment**—If line 23d is larger than the total of lines 22c and 24, enter amount overpaid ▶	26	-0-
	27 Enter amount of line 26 you want: **Credited to 1991 estimated tax** ▶ **Refunded** ▶	27	-0-

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ John H. Anders — Signature of officer
Date: 3-10-91
▶ Title: President

Paid Preparer's Use Only

Preparer's signature ▶
Date
Check if self-employed ▶ ☐
Preparer's social security number
Firm's name (or yours if self-employed) and address ▶
E.I. No. ▶
ZIP code ▶

For Paperwork Reduction Act Notice, see page 1 of separate instructions.

Form **1120S** (1990)

Form 1120S (1990) Page 2

Schedule A Cost of Goods Sold (See instructions.)

1	Inventory at beginning of year	1	126,000
2	Purchases	2	1,127,100
3	Cost of labor	3	-0-
4a	Additional section 263A costs (see instructions) *(attach schedule)*	4a	-0-
b	Other costs *(attach schedule)*	4b	-0-
5	Total—Add lines 1 through 4b	5	1,253,100
6	Inventory at end of year	6	298,400
7	Cost of goods sold—Subtract line 6 from line 5. Enter here and on line 2, page 1	7	954,700

8a Check all methods used for valuing closing inventory:

(i) ☐ Cost

(ii) ☑ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Writedown of "subnormal" goods as described in Regulations section 1.471-2(c)

(iv) ☐ Other (specify method used and attach explanation) ▶

b Check this box if the LIFO inventory method was adopted this tax year for any goods *(if checked, attach Form 970)* ▶ ☐

c If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **8c**

d Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the corporation? ☐ Yes ☑ No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? ☐ Yes ☑ No
If "Yes," attach explanation.

Additional Information Required (continued from page 1)

		Yes	No
I	Did you at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? For rules of attribution, see section 267(c). If "Yes," attach a schedule showing: **(1)** name, address, and employer identification number; and **(2)** percentage owned.		✓
J	Refer to the list in the instructions and state your principal: **(1)** Business activity ▶ 5008 - Distributor **(2)** Product or service ▶ Heavy Equipment		
K	Were you a member of a controlled group subject to the provisions of section 1561?		✓
L	At any time during the tax year, did you have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See instructions for exceptions and filing requirements for form TD F 90-22.1.) If "Yes," enter the name of the foreign country ▶		✓
M	Were you the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not you have any beneficial interest in it? If "Yes," you may have to file Forms 3520, 3520-A, or 926		✓
N	During this tax year did you maintain any part of your accounting/tax records on a computerized system?		✓

O Check method of accounting: **(1)** ☐ Cash **(2)** ☑ Accrual **(3)** ☐ Other (specify) ▶

P Check this box if the S corporation has filed or is required to file **Form 8264,** Application for Registration of a Tax Shelter ▶ ☐

Q Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐
If so, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.

R If the corporation: **(1)** filed its election to be an S corporation after 1986, **(2)** was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and **(3)** has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) ▶ $ 37,200

S Check this box if the corporation had subchapter C earnings and profits at the close of the tax year (see instructions) ▶ ☑

Designation of Tax Matters Person (See instructions.)

Enter below the shareholder designated as the tax matters person (TMP) for the tax year of this return:

Name of designated TMP ▶ John H. Anders

Identifying number of TMP ▶ 458 - 00 - 0327

Address of designated TMP ▶
4340 Holmes Parkway
Metro City, OH 43704

Schedule K Shareholders' Shares of Income, Credits, Deductions, Etc.

		(a) Pro rata share items			(b) Total amount
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)		1	119,000
	2	Net income (loss) from rental real estate activities *(attach Form 8825)*		2	
	3a	Gross income from other rental activities	3a		
	b	Less expenses *(attach schedule)*	3b		
	c	Net income (loss) from other rental activities		3c	
	4	Portfolio income (loss):			
	a	Interest income		4a	4,000
	b	Dividend income		4b	16,000
	c	Royalty income		4c	
	d	Net short-term capital gain (loss) *(attach Schedule D (Form 1120S))*		4d	
	e	Net long-term capital gain (loss) *(attach Schedule D (Form 1120S))*		4e	
	f	Other portfolio income (loss) *(attach schedule)*		4f	
	5	Net gain (loss) under section 1231 (other than due to casualty or theft) *(attach Form 4797)*		5	
	6	Other income (loss) *(attach schedule)*		6	
Deductions	7	Charitable contributions (see instructions) *(attach list)*		7	24,000
	8	Section 179 expense deduction *(attach Form 4562)*		8	
	9	Deductions related to portfolio income (loss) (see instructions) (itemize)		9	
	10	Other deductions *(attach schedule)*		10	
Investment Interest	11a	Interest expense on investment debts		11a	3,000
	b	(1) Investment income included on lines 4a through 4f above		11b(1)	20,000
		(2) Investment expenses included on line 9 above		11b(2)	
Credits	12a	Credit for alcohol used as a fuel *(attach Form 6478)*		12a	
	b	Low-income housing credit (see instructions):			
		(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990		12b(1)	
		(2) Other than on line 12b(1) for property placed in service before 1990		12b(2)	
		(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989		12b(3)	
		(4) Other than on line 12b(3) for property placed in service after 1989		12b(4)	
	c	Qualified rehabilitation expenditures related to rental real estate activities *(attach Form 3468)*		12c	
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities (see instructions)		12d	
	e	Credits related to other rental activities (see instructions)		12e	
	13	Other credits (see instructions) Jobs Credit		13	6,000
Adjustments and Tax Preference Items	14a	Accelerated depreciation of real property placed in service before 1987		14a	
	b	Accelerated depreciation of leased personal property placed in service before 1987		14b	
	c	Depreciation adjustment on property placed in service after 1986		14c	
	d	Depletion (other than oil and gas)		14d	
	e	(1) Gross income from oil, gas, or geothermal properties		14e(1)	
		(2) Deductions allocable to oil, gas, or geothermal properties		14e(2)	
	f	Other adjustments and tax preference items *(attach schedule)*		14f	
Foreign Taxes	15a	Type of income ▶			
	b	Name of foreign country or U.S. possession ▶			
	c	Total gross income from sources outside the U.S. *(attach schedule)*		15c	
	d	Total applicable deductions and losses *(attach schedule)*		15d	
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued		15e	
	f	Reduction in taxes available for credit *(attach schedule)*		15f	
	g	Other foreign tax information *(attach schedule)*		15g	
Other Items	16a	Total expenditures to which a section 59(e) election may apply		16a	
	b	Type of expenditures ▶			
	17	Total property distributions (including cash) other than dividends reported on line 19 below		17	65,000
	18	Other items and amounts required to be reported separately to shareholders (see instructions) *(attach schedule)*			
	19	Total dividend distributions paid from accumulated earnings and profits		19	
	20	Income (loss) (Required only if Schedule M-1 must be completed.)—Combine lines 1 through 6 in column (b). From the result subtract the sum of lines 7 through 11a, 15e, and 16a		20	112,000

SCHEDULE K-1
(Form 1120S)
Department of the Treasury
Internal Revenue Service

Shareholder's Share of Income, Credits, Deductions, Etc.

▶ **See separate instructions.**
For calendar year 1990 or tax year
beginning , 1990, and ending , 19

OMB No. 1545-0130

1990

Shareholder's identifying number ▶ 458-00-0327
Corporation's identifying number ▶ 10-4487965

Shareholder's name, address, and ZIP code
John H. Anders
4340 Holmes Parkway
Metro City, OH 43704

Corporation's name, address, and ZIP code
Estex, Inc.
482 Winston Street
Metro City, OH 43705

A Shareholder's percentage of stock ownership for tax year (see Instructions for Schedule K-1) ▶ 45 %
B Internal Revenue Service Center where corporation filed its return ▶ Cincinnati, OH
C (1) Tax shelter registration number (see Instructions for Schedule K-1) ▶
(2) Type of tax shelter ▶
D If the shareholder acquired corporate stock after 10/22/86, check here ▶ ☐ and enter the shareholder's weighted percentage increase in stock ownership for 1990 (see Instructions for Schedule K-1) ▶ %
E If any activity for which income or loss is reported on line 1, 2, or 3, was started or acquired by the corporation after 10/22/86, check here ▶ ☐ and enter the date of start up or acquisition in the date space on line 1, 2, or 3 **below.**
F Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

	(a) Pro rata share items		**(b) Amount**	**(c) Form 1040 filers enter the amount in column (b) on:**
Income (Loss)	1 Ordinary income (loss) from trade or business activities. If applicable, enter date asked for in item E ▶	1	53,550	See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	2 Net income (loss) from rental real estate activities. If applicable, enter date asked for in item E ▶	2		
	3 Net income (loss) from other rental activities. If applicable, enter date asked for in item E ▶	3		
	4 Portfolio income (loss):			
	a Interest	4a	1,800	Sch. B, Part I, line 1
	b Dividends	4b	7,200	Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f) or (g)
	e Net long-term capital gain (loss)	4e		Sch. D, line 12, col. (f) or (g)
	f Other portfolio income (loss) *(attach schedule)*	4f		(Enter on applicable line of your return.)
	5 Net gain (loss) under section 1231 (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	6 Other income (loss) *(attach schedule)*	6		(Enter on applicable line of your return.)
Deductions	7 Charitable contributions	7	10,800	Sch. A, line 14 or 15
	8 Section 179 expense deduction *(attach schedule)*	8		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	9 Deductions related to portfolio income (loss) *(attach schedule)*	9		
	10 Other deductions *(attach schedule)*	10		
Investment Interest	11a Interest expense on investment debts	11a	1,350	Form 4952, line 1
	b (1) Investment income included on lines 4a through 4f above	b(1)	9,000	See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	(2) Investment expenses included on line 9 above	b(2)		
Credits	12a Credit for alcohol used as fuel	12a		Form 6478, line 10
	b Low-income housing credit:			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
	(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
	(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c Qualified rehabilitation expenditures related to rental real estate activities (see instructions)	12c		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities (see instructions)	12d		
	e Credits related to other rental activities (see instructions)	12e		
	13 Other credits (see instructions) Jobs Credit	13	2,700	

For Paperwork Reduction Act Notice, see Form 1120S Instructions.

Schedule K-1 (Form 1120S) 1990

		(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Adjustments and Tax Preference Items	14a	Accelerated depreciation of real property placed in service before 1987	14a		See Shareholder's Instructions for Schedule K-1 (Form 1120S) and Form 6251 Instructions.
	b	Accelerated depreciation of leased personal property placed in service before 1987	14b		
	c	Depreciation adjustment on property placed in service after 1986	14c		
	d	Depletion (other than oil and gas)	14d		
	e	(1) Gross income from oil, gas, or geothermal properties	e(1)		
		(2) Deductions allocable to oil, gas, or geothermal properties	e(2)		
	f	Other adjustments and tax preference items *(attach schedule)*	14f		
Foreign Taxes	15a	Type of income ▶			Form 1116, Check boxes
	b	Name of foreign country or U.S. possession ▶			Form 1116, Part I
	c	Total gross income from sources outside the U.S. *(attach schedule)*	15c		Form 1116, Part I
	d	Total applicable deductions and losses *(attach schedule)*	15d		Form 1116, Part I
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f	Reduction in taxes available for credit *(attach schedule)*	15f		Form 1116, Part III
	g	Other foreign tax information *(attach schedule)*	15g		See Form 1116 Instructions
Other Items	16a	Total expenditures to which a section 59(e) election may apply	16a		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	b	Type of expenditures ▶			
	17	Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	17	29,250	
	18	Amount of loan repayments for "Loans from Shareholders"	18		
Recapture of Tax Credits	19	Recapture of low-income housing credit:			
	a	From section 42(j)(5) partnerships	19a		Form 8611, line 8
	b	Other than on line 19a	19b		

20 Investment credit properties:	A	B	C	
a Description of property (State whether recovery or nonrecovery property. If recovery property, state whether regular percentage method or section 48(q) election is used.)				Form 4255, top
b Date placed in service				Form 4255, line 2
c Cost or other basis				Form 4255, line 3
d Class of recovery property or original estimated useful life				Form 4255, line 4
e Date item ceased to be investment credit property				Form 4255, line 8

Supplemental Information

21 Supplemental information required to be reported separately to each shareholder *(attach additional schedules if more space is needed)*:

Tax-Exempt Interest	$ 2,250
Nondeductible Salaries & Wages Due To Jobs Credit	$ 2,700

Schedule L **Balance Sheets**

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash		14,700		14,514
2a Trade notes and accounts receivable	98,400		33,700	
b Less allowance for bad debts		98,400		33,700
3 Inventories		126,000		298,400
4 U.S. government obligations				
5 Tax-exempt securities		100,000		120,000
6 Other current assets *(attach schedule)*		26,300		26,300
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments *(attach schedule)*		100,000		100,000
10a Buildings and other depreciable assets	204,700		198,700	
b Less accumulated depreciation	6,000	198,700	5,200	193,500
11a Depletable assets				
b Less accumulated depletion				
12 Land (net of any amortization)		20,000		20,000
13a Intangible assets (amortizable only)				
b Less accumulated amortization				
14 Other assets *(attach schedule)*		14,800		19,300
15 Total assets		698,900		825,714
Liabilities and Shareholders' Equity				
16 Accounts payable		28,500		34,834
17 Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18 Other current liabilities *(attach schedule)*		6,800		7,400
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more		191,300		265,180
21 Other liabilities *(attach schedule)*				
22 Capital stock		200,000		200,000
23 Paid-in or capital surplus				
24 Retained earnings		268,000		314,000
25 Less cost of treasury stock		( )		( )
26 Total liabilities and shareholders' equity		698,900		825,714

Schedule M-1 **Reconciliation of Income per Books With Income per Return** (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than $25,000.)

1 Net income per books	102,270	5 Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize): a Tax-exempt interest $ 5,000	5,000
2 Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize):	-0-		
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16a (itemize): a Depreciation $ b Travel and entertainment $	16,350	6 Deductions included on Schedule K, lines 1 through 11a, 15e, and 16a, not charged against book income this year (itemize): a Depreciation $ 1,620	1,620
		7 Total of lines 5 and 6	6,620
4 Total of lines 1 through 3	118,620	8 Income (loss) (Schedule K, line 20)—Line 4 less line 7	112,000

Schedule M-2 **Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (See instructions.)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year	-0-	-0-	
2 Ordinary income from page 1, line 21	119,000		
3 Other additions	20,000	5,000	
4 Loss from page 1, line 21	(-0-)		
5 Other reductions	(33,000)	(-0-)	
6 Combine lines 1 through 5	106,000	5,000	
7 Distributions other than dividend distributions	65,000	-0-	
8 Balance at end of tax year—subtract line 7 from line 6	41,000	5,000	

The Examination and Appeals Process

We examine returns for correctness of income, exemptions, credits, and deductions.

Fairness If Your Return Is Examined

Most taxpayers' returns are accepted as filed. But if your return is selected for examination, it does not suggest that you are dishonest. The examination may or may not result in more tax. Your case may be closed without change. Or, you may receive a refund.

Courtesy and consideration. You are entitled to courteous and considerate treatment from IRS employees at all times. If you ever feel that you are not being treated with fairness, courtesy, and consideration by an IRS employee, you should tell the employee's supervisor. Publication 1, *Your Rights as a Taxpayer*, explains the many rights you have as a taxpayer. You can get free publications by calling our toll-free number.

Pay only the required tax. You have the right to plan your business and personal finances so that you will pay the least tax that is due under the law. You are liable only for the correct amount of tax. Our purpose is to apply the law consistently and fairly.

Privacy and Confidentiality. You have the right to have your tax case kept confidential. Under the law, the IRS must protect the privacy of your tax information. However, if a lien or a lawsuit is filed, certain aspects of your tax case will become public record. People who prepare your return or represent you must also keep your information confidential.

You also have the right to know why we are asking you for information, exactly how we will use it and what might happen if you do not give it.

Examination of Returns

An examination usually begins when we notify you that your return has been selected. We will tell you which records you will need.

How returns are selected. We select returns for examination by several methods. A computer program called the Discriminant Function System (DIF) is used to select most returns. In this method, the computer uses historical data to give parts of the return a score. IRS personnel then screen the return. Returns most likely to have mistakes are selected for examination.

Some returns are selected at random. We also select returns by examining claims for credit or refund and by matching information documents, such as Forms W–2 and 1099, with returns.

Arranging the examination. Many examinations are handled by mail. For information, get Publication 1383, *The Correspondence Process (Income Tax Accounts)*. If we notify you that your examination is to be conducted through a personal interview, or if you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If the time or place we suggest is not convenient, the examiner will try to work out something more suitable. However, we will make the final determination on how, when, and where an examination takes place.

Transfers to another district. Generally, your return is examined in the IRS district where you live. But if it can be examined more quickly in another district, such as where your books and records are kept, you may ask to have the case transferred to that district.

Representation. Throughout the examination, you may represent yourself, have someone else accompany you, or, with proper written authorization, have someone represent you in your absence. If you want to consult an attorney, C.P.A., an enrolled agent, or any other person permitted to represent a taxpayer during an examination, we will reschedule the interview. We cannot suspend the interview if you are there on administrative summons.

Recordings. You can generally make an audio recording of an interview with an IRS Examination officer. Your request to record the interview should be made in writing. You must notify us 10 days before the meeting and bring your own recording equipment. We also can record an interview. If we initiate the recording, we will notify you 10 days before the meeting and you can get a copy at your expense.

Repeat examinations. We try to avoid repeat examinations of the same items, but sometimes this happens. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so that we can see if we should discontinue the examination.

Explanation of changes. If we propose any changes to your return, we will explain the reasons for the changes. It is important that you understand the reasons for any proposed change. You should not hesitate to ask about anything that is unclear to you.

Agreement with changes. If you agree with the proposed changes, you may sign an agreement form and pay any additional tax you may owe. You must pay interest on any additional tax. If you pay when you sign the agreement, the interest is generally figured from the due date of your return to the date you paid.

If you do not pay the additional tax when you sign the agreement, you will receive a bill. The interest on this tax is generally figured from the due date of your return to the billing date. But you will not be billed for more than 30 days additional interest, even if the bill is delayed.

Appealing the Findings

If you do not agree with the examiner's report, you may meet with the examiner's supervisor to discuss your case further. If you still don't agree with the examiner's findings, you have the right to appeal them. The examiner will explain your appeal rights and give you a copy of Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases*. This free publication explains your appeal rights in detail and tells you exactly what to do if you want to appeal.

Appeals Office. You can appeal the findings of an examination within the IRS through our Appeals Office. The Appeals Office is independent of your examiner and IRS District Director or Service Center Director. Most differences can be settled this way without expensive and time-consuming court trials. If the matter cannot be settled to your satisfaction, you can take your case to court.

Appeals to the courts. Depending on whether you first pay the disputed tax, you can take your case to the U.S. Tax Court, the U.S. Claims Court, or your U.S. District Court. These courts are entirely independent of the IRS. However, a U.S. Tax Court case is generally reviewed by our Appeals Office before it is heard by the Tax Court. As always, you can represent yourself or have someone admitted to practice before the court represent you.

If you did not pay the additional tax and disagree that you owe it, you generally have the right to take your case to the Tax Court. Ordinarily you have 90 days from the time we mail you a formal notice (called a "notice of deficiency") saying that you owe additional tax to file a petition with the Tax Court.

If you already paid the disputed tax in full and filed a claim for refund (discussed later) that we disallowed (or did not take action on within 6 months), then you may take your case to the U.S. District Court or U.S. Claims Court.

Court decisions. We follow Supreme Court decisions. However, we can lose cases in other courts involving taxpayers with the same issue and still apply our interpretation of the law to your situation. You have the right to appeal our decision to do so.

Recovering litigation expenses. If the court agrees with you on most of the issues in your case, and finds the IRS's position to be largely unjustified, you may be able to recover some of your litigation expenses from us. But to do this, you must have used up all the administrative remedies available to you within the IRS, including going through our Appeals system. You may also be able to recover administrative expenses from the IRS.

Free Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, explains your appeal rights.

Other remedies. If you believe that tax, penalty, or interest was unjustly charged, you have rights which can remedy the situation.

Claims for refund. Once you pay your tax, you can file a claim for a credit or refund if you believe the tax is too much. The procedure is explained in Publication 556.

Cancellation of penalties. You have the right to ask that certain penalties (but not interest as discussed later) be canceled (abated) if you can show reasonable cause for the failure that led to the penalty (or can show that you exercised due diligence, if that is the applicable standard for the penalty).

If you relied on wrong advice given to you by IRS employees on the toll-free telephone system, we will cancel certain penalties that may result. But you have to show that your reliance on the advice was reasonable.

Reduction of interest. If our error caused a delay in your case, and this is grossly unfair, you may be entitled to a reduction of the interest which would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify. If you think we caused such a delay, please discuss it with the examiner and file a claim.

Business Taxpayers

If you are in an individual business, the rights covered in this discussion generally apply. If you are a member of a partnership or a shareholder in a small business corporation, special rules may apply to the examination of your partnership or corporation items. The examination of these items is discussed in free Publication 556.

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Tax Publications

On the following page, there is an order blank that you can use to send for any other IRS tax publications you need. Many of the publications that might be of interest to business taxpayers are listed below by their numbers and titles. This list includes all the publications referred to in the chapters of this book. A full list can be found in Publication 910, *Guide to Free Tax Services.*

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General Guides:

1 ..... Your Rights as a Taxpayer
17 ..... Your Federal Income Tax (For Individuals)
225 ..... Farmer's Tax Guide
509 ..... Tax Calendars for 1991
553 ..... Highlights of 1990 Tax Changes
595 ..... Tax Guide for Commercial Fishermen
910 ..... Guide to Free Tax Services

Employer's Guides:

15 ..... Employer's Tax Guide (Circular E)
51 ..... Agricultural Employer's Tax Guide (Circular A)
80 ..... Federal Tax Guide for Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)

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535 ..... Business Expenses
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560 ..... Self-Employed Retirement Plans
561 ..... Determining the Value of Donated Property
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909 ..... Alternative Minimum Tax for Individuals
911 ..... Tax Information for Direct Sellers
917 ..... Business Use of a Car
924 ..... Reporting of Real Estate Transactions to IRS
925 ..... Passive Activity and At-Risk Rules
926 ..... Employment Taxes for Household Employers
937 ..... Business Reporting (Employment Taxes and Information Returns)
1045 ..... Information and Order Blanks for Preparers of Federal Income Tax Returns
1048 ..... Filing Requirements for Employee Benefit Plans
1542 ..... Per Diem Rates
1544 ..... Reporting Cash Payments of Over $10,000

Spanish Language Publications:

179 ..... Guía Contributiva Federal Para Patronos Puertorriqueños (Circular PR)
556S ..... Revisión de las Declaraciones de Impuesto, Derecho de Apelación y Reclamaciones de Reembolsos
579S ..... Cómo Preparar la Declaración de Impuesto Federal
586S ..... Proceso de Cobro (Deudas del Impuesto sobre Ingreso)
850 ..... English–Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service

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1040	1040EZ	Schedule R (1040) & Instructions	2441 & Instructions	8582 & Instructions	Pub. 508	Pub. 553	
Instructions for 1040 & Schedules	Instructions for 1040EZ	Schedule SE (1040)	3468 & Instructions	8822	Pub. 521	Pub. 590	
1040A	Schedules A&B (1040)	1040-ES (1991)	3903 & Instructions	Pub. 1	Pub. 523	Pub. 910	
Instructions for 1040A, Sch. 1&2	Schedule C (1040)	1040X & Instructions	4562 & Instructions	Pub. 17	Pub. 525	Pub. 917	
Schedule 1 (1040A)	Schedule D (1040)	2106 & Instructions	4868	Pub. 334	Pub. 527	Pub. 929	
Schedule 2 (1040A)	Schedule E (1040)	2119 & Instructions	8283 & Instructions	Pub. 463	Pub. 529		
Schedule 3 (1040A) & Instructions	Schedule F (1040)	2210 & Instructions	8332	Pub. 505	Pub. 545		

Internal Revenue Service

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Number and street

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Checklist

Some of the federal taxes for which a sole proprietor, a corporation, or a partnership may be liable are listed below. If a due date falls on a Saturday, Sunday, or legal holiday, it is postponed until the next day that is not a Saturday, Sunday, or legal holiday. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state. For more information, see Publication 509, *Tax Calendars for 1991*.

You may be liable for	If you are:	Use Form	Due on or before
Income tax	Sole proprietor	Schedule C (Form 1040)	Same day as Form 1040
	Individual who is a partner or S corporation shareholder	1040	15th day of 4th month after end of tax year
	Corporation	1120 or 1120-A	15th day of 3rd month after end of tax year
	S corporation	1120S	15th day of 3rd month after end of tax year
Self-employment tax	Sole proprietor, or individual who is a partner	Schedule SE (Form 1040)	Same day as Form 1040
Estimated tax	Sole proprietor, or individual who is a partner or S corporation shareholder	1040-ES	15th day of 4th, 6th, and 9th months of tax year, and 15th day of 1st month after the end of tax year
	Corporation	1120-W	15th day of 4th, 6th, 9th and 12th months of tax year
Annual return of income	Partnership	1065	15th day of 4th month after end of tax year
Social security (FICA) tax and the withholding of income tax	Sole proprietor, corporation, S corporation, or partnership	941	4-30, 7-31, 10-31, and 1-31
		8109 (to make deposits)	See Chapter 32
Providing information on social security (FICA) tax and the withholding of income tax	Sole proprietor, corporation, S corporation, or partnership	W-2 (to employees)	1-31
		W-2 and W-3 (to the Social Security Administration)	Last day of February
Federal unemployment (FUTA) tax	Sole proprietor, corporation, S corporation, or partnership	940-EZ or 940	1-31
		8109 (to make deposits)	4-30, 7-31, 10-31, and 1-31, but only if the liability for unpaid tax is more than $100
Information returns for payments to nonemployees and transactions with other persons	Sole proprietor, corporation, S corporation, or partnership	See Chapter 36	Forms 1099—to the recipient by 1-31 and to the Internal Revenue Service by 2-28 Other forms—see Chapter 36
Excise taxes	Sole proprietor, corporation, S corporation, or partnership	See Chapter 35	See the instructions to the forms

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